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Comment letter to proposed statement of position : Accounting for the costs of computer software developed or obtained for internal use;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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Letter #	Organization	Category	Respondent name
1	Booke Seminars	PREP	Harry Harkey
2	Individual	OTH	George B. Fineberg
3	Mellon Bank	PREP	Steven Elliott
4	Blue & Co.	PUB	Michael Alerding
5	Sunkist Growers	PREP	H. B. Flach
6	Individual	PUB	Earl Rodney
7	Harman International Industries, Inc.	PREP	David Eelman
8	Loyola University Chicago	ACAD	Charles Werner
9	Carter & Associates	PUB	John R. Carter
10	Old Kent Financial Corp.	PREP	Albert T. Potas
11	Baker Hughes	PREP	James E. Braun
12	Individual	PUB	Sharon Vanzant
13	New York State Society	SOC	William M. Stocker
14	3M	PREP	Ronald G. Nelson
15	Financial Institutions Accounting Committee	OTH	James W. Bean
16	Connecticut Society of CPAs	SOC	Paul Rohan
17	R.G. Associates, Inc.	USER	Jack Ciesielski
18	Arkansas Society of CPAs	SOC	Barbara S. Angel
19	Institute of Management Accountants	OTH	L. Hal Rogero
20	Union Camp	PREP	John F. Haren
21	Lucent Technologies	PREP	James S. Lusk
22	NationsBank	PREP	Marc D. Oken
23	WMX Technologies, Inc.	PREP	Thomas C. Hau
24	Individual	OTH	Michael J. Kolesar
25	New England Investment Companies, L.P.	USER	G. Neal Ryland
26	Medtronic, Inc.	PREP	Gary L. Ellis
27	Stanford University	PREP	M. Suzanne Calandra
28	Barron's	USER	Kathryn M. Welling

Letter #	Organization	Category	Respondent name
29	Meadowbrook Insurance Group	PREP	Suzanne R. Vahratian
30	Sprint	PREP	John P. Meyer
31	Individual - ICU Medical, Inc.	PREP	Francis J. O'Brien
32	Long Island Bancorp	PREP	Mark Fuster
33	INSO Corporation	PREP	Betty J. Savage
34	Primadonna	PREP	Louis W. Sanford
35	Pepsico	PREP	Robert L. Carleton
36	Norwest Corporation	PREP	Michael A. Graf
37	BellSouth Corporation	PREP	W. P. Shannon
38	MBNA America Bank, N.A.	PREP	M. Scot Kaufman
39	Hercules Incorporated	PREP	George MacKenzie
40	AEtna	PREP	Robert J. Price
41	Pfizer	PREP	Herbert V. Ryan
42	Wells Fargo & Company	PREP	Frank A. Moeslein
43	The McGraw-Hill Companies	PREP	Thomas J. Kilkenny
44	Motorola	PREP	Ken Johnson
45	USAA	PREP	
46	Federal Communications Commission	USER	Kenneth Moran
47	Northwest Airlines	PREP	Mark W. Osterberg
48	U.S. Telephone Association	OTH	Porter E. Childers
49	The LTV Corporation	PREP	George T. Henning
50	Ameritech	PREP	Ronald G. Pippin
51	Summit Bancorp	PREP	William J. Healy
52	The Chase Manhattan Corporation	PREP	Joseph L. Sclafani
53	Citicorp	PREP	Roger W. Trupin
54	Allstate Insurance Company	PREP	Samuel H. Pilch
55	Deloitte & Touche LLP	PUB	Naomi Erickson
56	Fidelity Investments	USER	Gerald M. Lieberman

Letter #	Organization	Category	Respondent name
57	John Hancock Mutual Life Insurance Company	PREP	Janet A. Pendelton
58	Caterpillar Inc.	PREP	R.R. Gallagher
59	The Williams Companies, Inc.	PREP	Gary R. Belitz
60	Thiokol Corporation	PREP	Michael R. Ayers
61	American Express Company	PREP	Daniel T. Henry
62	Aerospace Industries Association	OTH	LeRoy J. Haugh
63	AICPA Industry Committee	PREP	Holly L. Nelson et al
64	General Electric Company	PREP	Philip Ameen
65	Technical Issues Committee	PUB	James A. Koepke
66	Cincinnati Bell Inc.	PREP	Gerard J. Brinkman
67	Wyoming Public Service Commission	USER	Steve Ellenbecker et al
68	Heller International Corp.	PREP	Lawrence G. Hund et al
69	Metropolitan Life Insurance Company	PREP	H. Wayne Thrasher
70	Mobil Corporation	PREP	M.F. Keeth
71	Florida Public Service Commission	USER	Cynthia B. Miller
72	The Walt Disney Company	PREP	John J. Garand
73	Chevron Corporation	PREP	S. J. Crowe
74	Textron Incorporated	PREP	W. Christopher Rees
75	VoltDelta Resources	USER	Cynthia M. Allen
76	Burlington Resources	PREP	Curtis H. Threat
77	BankAmerica	PREP	Paul R. Ogorzelec
78	Texas Society of CPAs	SOC	Steven R. Goodman et al
79	Abbott Laboratories	PREP	Frank J. Loughery
80	NYNEX	PREP	Mel Meskin
81	Maryland Association of CPAs	SOC	SOC
82	Kerr-McGee Corporation	PREP	Deborah A. Kitchens
83	The Gillette Company	PREP	Albert S. DePiero
84	Comerica Incorporated	PREP	Marvin J. Elenbaas

Letter #	Organization	Category	Respondent name
85	USX Corporation	PREP	Kenneth L. Matheny
86	Phillips Petroleum Company	PREP	J.K. Wagner
87	Investment Company Institute	USER	Gregory M. Smith
88	Michigan Public Service Commission	USER	Hasso C. Bhatia
89	KeyCorp	PREP	Lee Irving
90	Duke Power Company	PREP	Jeffrey L. Boyer
91	Texas Instruments Incorporated	PREP	William A. Aylesworth
92	Wisconsin Public Service Commission	USER	Cheryl Parrino
93	General Mills, Inc.	PREP	Edgar G. Kroner
94	Blank		
95	Rockwell International - subdivision	PREP	Patricia A. Nemeth
96	Ford Motor Company	PREP	Eric A. Law
97	Louisiana Society of CPAs	SOC	Judson McCann
98	Eaton Corporation	PREP	Billie K. Rawot
99	Salt River Project	PREP	Deborah Kimberly
100	SBC Communications Inc.	PREP	Randall Stephenson
101	Unocal Corporation	PREP	Charles S. McDowell
102	Black & Decker	PREP	Stephen F. Reeves
103	People's Bank	PREP	Carlos R. Mello
104	Northern Telecom	PREP	Adrian Donoghue
105	Coopers & Lybrand	PUB	James F. Harrington
106	Warner Lambert	PREP	Joseph E. Lynch
107	Ernst & Young	PUB	Ernst & Young
108	Union Pacific Corporation	PREP	Joseph O'Connor
109	Consumers Energy	PREP	Dennis DaPra et al
110	Robert Morris Associates	USER	Douglas Nelson
111	Wachovia Bank of North Carolina, N.A	PREP	Albert DeForest
112	Massachusetts Society of CPAs	SOC	Thomas Vocatura

Letter #	Organization	Category	Respondent name
113	Merrill Lynch	PREP	Michael Castellano
114	AIMR	USER	Peter Knutson et al
115	Boeing	PREP	David Sjogren
116	Sonat Inc	PREP	William Johnson
117	Price Waterhouse	PUB	David Kaplan
118	Texaco	PREP	R.C. Oelkers
119	General Motors	PREP	Peter Bible
120	Cigna	PREP	Gary Swords
121	GTE	PREP	Michael Kelly
122	Grant Thornton	PUB	Joseph Graziano
123	Individual	USER	Charles Phillips
124	Arthur Andersen	PUB	Richard Dieter
125	Philip Morris	PREP	Frank Toscano
126	FMC Corporation	PREP	Michael Callahan
127	National Securities Clearing Corporation	PREP	Robert Bennett

December 17, 1996

Accompanying this letter is an exposure draft of a proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. A summary of the proposed SOP is included in the forepart of that document.

The purpose of this exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.

The proposed SOP would apply to all entities that prepare financial statements in conformity with generally accepted accounting principles applicable to nongovernmental entities.

Areas Requiring Particular Attention by Respondents

Comments are specifically requested on the following issues addressed by this exposure draft:

yes

(1) Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such
NO costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting? *Paragraphs 50-67 provide the basis for*
yes *AcSEC's conclusions.*

(2) This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP 60 mo F.I.T.
yes require certain methods of amortization? If so, why, and what methods should be required? *Paragraph 75 provides the basis for AcSEC's conclusions.*
No

(3) Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of yes
yes internal-use computer software assets? *Paragraphs 72-74 provide the basis for AcSEC's conclusions.*

(4) This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of yes computer software developed or obtained for internal use? If so, what are those criteria? *Paragraphs 44-49 provide the basis for AcSEC's conclusions.*

(5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What
No

costs should be included or excluded? *Paragraph 68 provides the basis for AcSEC's conclusions.*

(6) Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why? *Paragraphs 38-43 provide the basis for AcSEC's conclusions.*

yes

(7) Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated? *Paragraphs 38-43 provide the basis for AcSEC's conclusions.*

yes

(8) The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational? *Paragraphs 63-64 provide the basis for AcSEC's conclusions.*

yes

AcSEC welcomes comments or suggestions on any aspect of the exposure draft. When making comments, please include references to specific paragraph numbers, include reasons for any suggestions or comments, and provide alternative wording where appropriate.

Comments on the exposure draft should be sent to Daniel Noll, Technical Manager, Accounting Standards, File 4262, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by April 17, 1997. Responses may also be sent by electronic mail over the Internet to DNOLL@AICPA.ORG.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA's offices for one year after April 17, 1997.

Sincerely,

G. Michael Crooch, CPA
Chair
Accounting Standards
Executive Committee

Philip D. Ameen, CPA
Chair
Internal-Use Computer
Software Task Force

Jane B. Adams

Jane B. Adams, CPA
Director
Accounting Standards

GEORGE B. FINEBERG,MBA,CPA

Telephone (301)299-8574
Fax (301)299-6574 (By Appointment)

8178 Inverness Ridge Road
Potomac, MD 20854-4013

January 10, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Daniel Noll,

I offer the following comment on the December 17, 1996 Exposure Draft of the Proposed Statement of Position concerning "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

I believe that the initial costs of training incurred during the implementation stage to prepare existing staff for the use of the new software should be capitalized and amortized over the expected useful life of the software. The outcome of such training is often to identify flaws in the software that must be corrected prior to full, normal operation. This would probably be true also for major modifications or additions to existing software. Subsequent recurrent proficiency training or training of new employs would, I believe be more properly treated as operating expenses as incurred.

Thank you for the opportunity to comment on this exposure draft.

Sincerely,

George B. Fineberg

GEORGE B. FINEBERG

Mellon Bank Corporation

One Mellon Bank Center
Pittsburgh, PA 15258-0001
(412) 234-4611

Steven G. Elliott
Vice Chairman and
Chief Financial Officer

January 9, 1997

Mr. Daniel Knoll, Technical Manager
Accounting Standards, File 4262
AICPA, 1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed SOP: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Knoll:

Mellon Bank Corporation (Mellon) is a $43 billion asset bank holding company with headquarters in Pittsburgh, Pennsylvania. Mellon also owns The Dreyfus Corporation. Mellon enthusiastically supports the proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." With regard to the specific issues you raised for comment, we submit the following:

- The development of computer software is an extensive process in the banking and mutual fund industries. Mellon believes that most computer software applications for internal use meet the definition of an asset because : a) software applications involve a capacity to contribute directly or indirectly to future net cash inflows; b) an entity can obtain the benefit and control others' access to it; and c) the transactions giving an entity the right to control the benefit have already occurred.

- Capitalized software meets the definition of a financial statement element that is measurable with sufficient reliability, and is clearly relevant in making business decisions, and the capitalized amount is representationally faithful and verifiable. Mellon believes that state-of-the-art software applications provide a competitive advantage in the delivery of banking, trust or mutual funds products and the software is often a more valuable asset than fixed assets recognized under GAAP.

- We agree that the proposed SOP should not specify a maximum amortization period because of the large diversity of computer software applications that exist. We think that each company can best determine the life of individual software applications in conjunction with their certified public accountants.

- We recommend that computer software be subject to the impairment rules of FAS 121. We acknowledge that fair value may be difficult to obtain or may be not applicable; it also may be difficult to estimate cash flows from a particular software application. However, we think that the events specified in FAS 121, paragraph 5, provide the recognition events for recording an impairment. Perhaps the most important event in the assessment of computer software is whether the software is still enabling the company to deliver top-quality, competitive services to its customers or to provide the financial or administrative information needed to process daily transactions or to prepare financial statements for shareholders and regulators. Since fair values and cash flows may be difficult to assess, it may be advisable for the SOP to provide that any software no longer meeting preferred customer service requirements or administrative requirements should be totally written off whether or not the software is removed from use.

- Mellon agrees with expensing software development costs for research and development. However, for other software used for customer service and financial and administrative purposes, technical feasibility is not applicable. For customer service and administrative applications, technical feasibility is generally not a relevant test because individual companies can control the software development to meet their particular customer service or administrative needs. Mellon believes that internal software development should proceed under the capitalization principles of other long-lived assets such as buildings or equipment, except for limitations on capitalizable costs as discussed below.

- We agree with the proposed SOP's approach to capitalizable costs. External direct costs of materials and services have control by competition in keeping costs reasonable. It is also reasonable to limit internal costs to salaries and benefits for employees who develop the software and not to include other overhead costs. Under the guidance of FAS 34, it is appropriate to recognize interest costs during the development period.

- Mellon believes that for most companies it will be quite easy to distinguish software development for internal use from software development to be sold or leased and thereby subject to FAS 86. We agree that for mixed use property that it is impractical and difficult to allocate costs between internal-use software and software to be marketed and we therefore agree that development of software to be sold should come under the guidance of FAS 86.

In summary, Mellon endorses the proposed SOP and believes that the importance of software as a business asset certainly makes this a timely document. Should you wish to discuss any of our views, you may call Mr. Michael K. Hughey at (412) 234-5666 or Mr. Howard S. Fahnestock at (412) 234-5281.

Sincerely,

Steven G. Elliott
Vice Chairman and
Chief Financial Officer

Offices in Indianapolis • Seymour • Rensselaer • Columbus • Louisville

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Integrity • Teamwork • Commitment

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January 16, 1997

Daniel J. Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Exposure Draft - Proposed Statement of Position
"Accounting for the Costs of Computer Software
Developed or Obtained for Internal Use"

Dear Daniel:

The following are our responses to the above Exposure Draft. Each response number corresponds to the specific "Areas Requiring Particular Attention by Respondents" on the opening pages of the Exposure Draft.

1. Costs of computer software developed or obtained for internal use <u>should</u> be capitalized. Entities should not have the option of expensing such costs. The benefits of improving the quality of reported earnings (e.g. matching concept) outweigh the costs, which are believed to be minor. Identifying and valuing payroll costs will be the most difficult element to quantify, but even in the smallest client, the benefits will still outweigh the costs.

2. The concept of capitalization is rational because these costs are long lived assets that benefit many future periods. GAAP does not specify lives for other similar assets and, therefore, there is no reason to be specific in mandating the amortization period or method in the case of this type of cost.

3. Yes. Also, the proposed SOP <u>does</u> provide sufficient guidance.

4. Generally, entities recognize, in the conceptual stage of development, the purpose for or use of the software. It would be only in a very few cases where the issue of R & D comes into play. Accordingly, we do <u>not</u> think that an entity should be required to meet the technology feasibility criteria.

5. No

6. Yes

7. If the entity intends to develop or obtain software for both internal use and external marketing, the guidance of FASB Statement 86 should be followed. As a general rule in this type of situation, the underlying intent is to develop a product for resale and not strictly for internal use. Far too much time, effort and confusion may arise if some arbitrary allocation method is used.

8. Yes

We hope our response helps you finalize this pronouncement and gives you feedback that represents small, closely-held entities, including nongovernmental not-for-profit entities. If you have any questions, please feel free to contact the undersigned.

Very truly yours,

Michael P. Alerding
Director

MPA:djg

Sunkist

January 21, 1997

Sunkist Growers
Post Office Box 7888
Van Nuys, CA 91409-7888
Tel: (818) 986-4800

Mr. Daniel Noll, Technical Manager,
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Sir:

I am the CFO of Sunkist Growers, a California based marketing cooperative with annual revenues in excess of $1 billion. I have the responsibility for, among other things, managing the accounting function at Sunkist, including financial reporting. I have held a California CPA license since about 1963 and have been a member of the AICPA all of that time as well.

I am really bothered by the direction AcSEC is going in the proposed SOP dealing with Accounting For The Costs of Computer Software Developed or Obtained for Internal Use. My objections are both philosophical and practical.

Whatever happened to the basic concept of conservatism in the development of accounting theory? The conclusions of the proposed SOP are what I'd expect to see in a tax proposal submitted to Congress, but not in an accounting pronouncement. The idea of capitalizing costs of such a nebulous nature on the balance sheet, instead of writing them off as incurred, strikes me as being contrary to the principles of accounting as I've always understood them. I understand the principle of matching costs and expenses in the same accounting period as the "resulting" revenues or benefits are realized, but I fail to see where these new rules would improve matters any.

I can only draw upon my own experiences at Sunkist to make my case. Over the years we've had numerous occasions where we've needed to replace old software applications with new ones or have needed to develop applications where none had existed before. Our policy has always been to look for an existing "package" first, because our rule of thumb is that it will cost us ten times as much to "reinvent the wheel" than to adapt to an existing purchased software application. The reasons for that are rather obvious, and I believe most people will agree that the cost relationships between internally developed and purchased are a high ratio. Whether it's ten or five or fifteen, the point's the same.

For many years now the Internal Revenue Code has required the capitalization of purchased software, and accounting theory has followed, quite properly I feel. Such purchases represent the acquisition of a capital asset expected to be used over a period of time and capitalizing and amortizing accomplishes a matching of costs over the period of use or benefit.

In a perfect world a similar approach might make sense for internally developed software. But the real world is far from perfect. Virtually any software application involves at least two people, the "user" and the programmer-analyst. Usually there are multiple users, a team of analysts and programmers, and layers of management and supervision above that. It's a rare situation indeed where a user is able to so clearly define his system requirements that the programmer-analyst can be given them and go off and efficiently directly create the end-use software. The norm is that users change their minds and otherwise evolve their requirements during the course of the project and the programmer-analyst often has to discard parts of his creation and start over to deal with such evolving changes. Without the discipline of a purchased software application, these things happen frequently.

Now, to the practicalities. Do we capitalize the false starts and the inefficiencies brought about by "as we go" changes? Do we capitalize part of the costs of the programmer-analyst's manager and supervisor who, in a "shirt sleeve environment", may end up spending time helping out with solutions to different design problems? How about the hours they all spend on Monday mornings discussing the weekend's football games? I think we're opening up Pandora's box if we're creating an opportunity to have what I've described as "inefficiency costs" capitalized and amortized over future years' budgets. That's not accounting conservatism and it will lead to the creation of some really doubtful assets on the balance sheet.

In my mind the facts and circumstances justify treating purchased software and internally developed software differently. I'm not swayed by the "matching" argument. If we're to rationalize capitalizing the cost of a programmer-analyst because he's working on a system that will be used in future years, then why not capitalize the time of a management team who put together a long-term plan for the organization? Presumably the benefits of the plan will be realized in future years , so why not capitalize the cost of developing the plan? How about advertising costs which presumably will translate into increased sales revenues over future accounting periods? Capitalize them? How about market development costs? We spend a lot of money every year doing those things that we hope will lead to opportunities to do business in places like Korea and China in years to come. Do we capitalize those costs?

Obviously the point I'm trying to make is that capitalizing developed software costs is a violation of the principle of conservative accounting, and I don't think it does much to further the application of the "matching" principle either. I also see a great many practical problems of measurement and valuation of cost considered for capitalization. I see the logic of the proposal leading to some very ridiculous next steps, as witnessed by my questions relating to advertising, market development, and many other costs incurred "today" with a hope of a benefit being returned "tomorrow". And finally, if this proposal is adopted, I'm sure the Congressional eyes watching us are going to adopt the same change for tax purposes, and we've walked head-long into another "de-facto" tax increase. Let's don't give the government any more bad ideas. They seem capable of coming up with enough on their own.

To conclude, this is one of those instances where the best action to take is no action at all. The proposed cure would be far worse than any perceived problem which may exist today.

I do appreciate this opportunity to vent myself and I do hope that cooler heads prevail. Thank you for hearing me out.

Sincerely,

H. B. Flach
Vice President, Finance & Administration

EARL RODNEY, P.A.

CERTIFIED PUBLIC ACCOUNTANT

MEMBER OF
AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

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February 5, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The costs associated with computer software developed or obtained for internal use are ongoing business expenses, just like any other systems or procedures expenditure, and should be expensed as incurred.

With today's rapidly changing technology and business environment, there is no assurance that the computer software aquired now will have a long-lived useful life in an uncertain future. Therefore, capitalization of such costs would create a fictitious asset with an unrealistic period of future amortization.

Yours truly,

Earl Rodney

Earl Rodney, CPA, MSM

Author: MIME:DEELMAN@harman.com at INTERNET
Date: 2/12/97 2:25 PM
Priority: Normal
TO: -:dnoll@aicpa.org at INTERNET
TO: Daniel J. Noll at AICPA3
Subject: Software ED

----------------------------------- Message Contents -----------------------------------

I have studied the Exposure Draft of the Proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." I also attended a conference in New York, New York, on September 30, 1996, in which Michael Crooch of AcSEC presented this issue and AcSEC's views.

I endorse this proposed SOP and recommend its approval.

David A. Eelman, CPA
Member-AICPA
Director, Consolidations and Reporting
Harman International Industries, Inc. (HAR-NYSE)
1101 Pennsylvania Ave., NW
Washington, DC 20004

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February 17, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of CPA's
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Accounting for the Costs of Computer Software Developed
or Obtained for Internal Use

Dear Mr. Noll:

As a purely practical matter, I believe the AICPA Accounting Standards Executive Committee is making a most egregious mistake in the Software SOP.

Internally developed software comes in an extensive number of forms from large complex projects to small and simple projects. Often smaller and/or closely held businesses have no acceptable cost accumulation system for such matters. Thus, the data available for financial statements under a mandatory capitalization policy is likely to be highly estimated for such enterprises at best. While the amounts are often material to net income, the effort necessary for data accumulation (if you capitalize) will be throwing money in the street for small business.

Moreover, present Internal Revenue Service rules in Revenue Procedure 69-21, 1969-2 CB 303, permit a consistent policy of expensing such costs. The lesson of FASB 34 on capitalization of interest has apparently not been learned. FASB 34 tipped off the IRS to a great idea...why not capitalize interest for tax purposes? The result was Internal Revenue code Section 189 causing billions of dollars of tax deductions to be deferred. Now the AICPA would take away a perfectly good tax deduction and probably get the pernicious doctrine of interest capitalization extended to another area (if the IRS acts as you know they will). I know that expected tax effects cannot control GAAP, but this would be a sensible area to keep the present alternatives.

I would permit alternative measurement in this area particularly for smaller/closely held businesses. Capitalization should be optional, not mandatory, GAAP.

Incidentally, capitalization of the cost of purchased software matches current IRS policy with a three-year amortization period under Code Section 167 (f).

Cordially yours,

Charles A. Werner
Accounting Professor

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February 21, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-9775

Dear Mr. Noll:

I have read the Proposed Statement of Position regarding accounting for the costs of computer software developed or obtained for internal use. It appears that one portion of the proposal is in conflict with many other GAAP applications.

Specifically, the statement requires capitalization of only employee payroll and related payroll costs to arrive at the cost of the project and excludes "general and administrative" and "overhead" costs; the statement then goes on to require capitalization of interest.

It seems to me that the "overhead" (Rent, supplies, utilities, etc.) related to the group developing the software (generally the Management Information Services department) should be capitalized as a component of the cost of the software. I cannot understand why AcSEC would move to a direct costing concept for this single item.

I would like to point out the following arguments which support the capitalization of related overhead:

1) *Since about 1940, it has been generally accepted (and required) that factory overhead be included as a component of inventory pricing. If the "cost" of inventory includes such overhead, why wouldn't the cost of developed software include similar items?*

2) *FASB Statement 86 does not impose a similar direct costing requirement for measuring the cost of software to be sold, leased or otherwise marketed. Why should the methodology for measuring the two costs be different?*

3) *I could give you many more examples where items which are manufactured (i.e., self created) include directly related overhead as a component of cost. To quote Charles Horngren's Cost Accounting - "overhead is applied ... because of the managerial need for a close approximation of costs...".*

If the profession is going to move to direct costing we should frame the debate from that point of view and not use a back door exception by singling out internally manufactured software for internal use. The overhead directly supporting such efforts can easily be equal to the direct costs and this results an extremely poor matching of costs with revenue.

Sincerely,

John R. Carter

John R. Carter #133715
CARTER & ASSOCIATES

OLD KENT

Old Kent Financial Corporation
One Vandenberg Center
Grand Rapids, MI 49503

March 3, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036-8775

RE: Exposure Draft—Proposed Statement of Position
Accounting for the Cost for Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

Please accept these comments on the aforementioned Exposure Draft. With two exceptions, Old Kent Financial Corporation supports the Exposure Draft as written. The exceptions are as follows (both regard the subject of amortization):

1. Paragraph 30 of the Exposure Draft states that computer software should be amortized over the estimated useful life of the software. We would suggest that a maximum amortization period be specified perhaps 30 years (as an upper limit deterrent against bad judgment).

2. Paragraph 32 of the Exposure Draft states that software should be amortized when it is ready for the intended use, regardless of whether it's placed in service. We disagree:

   A. It is inconsistent with depreciation on plant property and equipment, which it begins its depreciation when placed in service to achieve the matching concept of revenues and expenses.

   B. Furthermore, legitimate business conditions may dictate that an acceleration or deferral from the original intended date may be appropriate based on circumstances surrounding.

Please feel free to contact me if you have any questions on these comments.

Yours truly,

Albert T. Potas

Albert T. Potas
Senior Vice President
and Controller
(616) 771-1931

cc: Mr. Joe Moravy, Arthur Andersen LLP

James E. Braun
Controller

March 20, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York NY 10036-8775

Proposed Statement of Position - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. - File 4262

Dear Mr. Noll:

We are pleased to comment on the AICPA's exposure draft on the above referenced item dated December 17, 1996. Our response is organized along the eight issues identified in the exposure draft. The original issues are not repeated.

Issue (1)

Entities should be required to capitalize and recognize as assets the costs of computer software developed or obtained for internal use. The costs of reporting should not be burdensome as entities should be capturing the type of information necessary to account for such costs as assets. Such purposes would include authorization for expenditure, return on investment, payback and the like. Expenditures in this area are greater today, relative to prior spending, as entities continue to utilize technology, including software, as a strategic weapon in an increasingly competitive marketplace. As such, these costs represent a major investment that will be monitored. The on-going costs of reporting should not be significant.

Issue (2)

The SOP should have a rebuttable presumption that the capitalized cost should be amortized on a straight-line basis over the estimated useful life of the software, not to exceed 15 years. A straight-line method is most likely the current practice, although, other methods may develop which provide a more reliable method of matching the costs of the software with the benefits. For reasons similar to the requirement that goodwill not be amortized longer than 40 years, there should be a limit on the period of amortization of the capitalized costs. Current practice, most likely, is to amortize such costs over a period of three to 15 years with the constant and accelerating change in technological advances in this area being one of the reasons for the relatively short lives. This change will continue at a rapid pace and a 15 year maximum life seems appropriate.

Baker Hughes Incorporated
3900 Essex Lane, Suite 1200, P.O. Box 4740, Houston, Texas 77210-4740, 713/439-8732

Issue (3)

FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, should be used in determining the recognition and measurement of impairments of internal-use computer software. Providing specific guidance on how to recognize and measure an asset such as software that supports the operations of an entity is difficult at best and, is best addressed by the FASB as an implementation issue of SFAS No. 121. However, the guidance in paragraph 29 is sufficient in that software is generally completed and placed in service or not.

Issue (4)

An entity should not be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use. The requirements in paragraph 20 of the proposed SOP are understandable and operational.

Issue (5)

The types of costs that should be capitalized are appropriate. The requirement that "payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project" will present challenges to entities as the lines between activities such as reengineering, continuous improvement and development activities are in practice blurred. Systems and processes will need to be developed to track such costs and activities.

Additional guidance and clarification as to the dividing lines between reengineering, continuous improvement and development activities would be helpful in implementing this proposed SOP. We believe that practice will evolve where costs of "blurred" activities will be capitalized; although, the requirements of paragraph 26 seems to indicate that the costs to be capitalized would be more restrictive and limited.

Issue (6)

The delineation between internal-use software and non internal-use software seems obvious; however, the guidance is consistent with what common sense would dictate.

Issue (7)

An entity should follow the guidance of either the proposed SOP or FASB Statement No. 86, but not both, based on a determination of what is the primary purpose for which expenditures are being made. That is, for internal use or for the sale to third parties.

Issue (8)

The guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance is operational.

We hope you find our comments helpful in considering the issuance of this standard.

Sincerely,

James E. Braun

James E. Braun
Controller

Sharon A. Vanzant, CPA

Business Consulting and
Accounting Services

2785 Pacific Coast Hwy Suite E215
Torrance, CA 90505

(310) 618-0935

February 25, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Stars
New York, New York 10036-8775

Dear Mr. Noll:

To assist you and AcSEC in determining the appropriate accounting for the costs of computer software developed or obtained for internal use, I have reviewed the exposure draft of the Statement of Position (SOP), and formulated comments based on my experience in the telecommunications industry. For ease of review, I will organize my comments as answers to the questions posed by AcSEC in the introduction to the SOP.

(1) It is my belief that costs of computer software developed or obtained for internal use should be recognized as an asset and that entities should not have the option of expensing such assets. I have formed this conclusion for many of the same reasons as discussed by the SOP, as well as for comparability of the results of operations of service companies, such as telecommunications companies with manufacturing companies.

In a manufacturing company, significant capital is often expended to purchase the property, plant and equipment (PP&E) necessary to produce the products which are subsequently sold. The costs of these assets are capitalized and amortized over their expected life, resulting in a proper matching of the expense of producing the products sold, and the revenue generated from the product sales. In service industries, there is often little investment in PP&E, as no products are manufactured. Instead, services are often rendered through sophisticated computer programs. For instance, a company providing billing and collection, rating, and formatting services to telecommunications service providers may have only $100,000 - 200,000 invested in computer hardware to provide its services. However, to provide these same services the company may have several million dollars invested in the computer software. By expensing the cost of the software when purchased or developed, the company would have significantly lower earnings in the year of purchase or development, and significantly higher earnings in the subsequent years than a manufacturer, with the same investment in PP&E and similar revenue and cost structure. This disparity of treatment makes it extremely difficult for potential investors and creditors to compare the two companies and make informed investment and credit decisions. Additionally, in the current environment, companies in the same industry may account for costs of purchased or developed software for internal use differently, making the comparisons within an industry equally difficult.

By requiring that all costs of purchasing or developing software for internal use be capitalized and expensed over their estimated useful lives, AcSEC is putting back consistency of accounting treatment between industries, and often within an single industry.

The additional costs incurred by a company to properly report the costs of internal-use computer software would be limited to tracking the activities of the staff working on software development projects. All external costs could be accounted for via vendor invoices at no incremental cost. The cost of tracking staff activities should be minimal, and would be far outweighed by the benefits derived by a better matching of expenses with revenue, and consistency among reporting entities.

(2) As is the case with PP&E and intangible assets, the establishment of the amortization period and method should be left to the individual company, as long as the period and method are supportable, and consistent with the treatment of other long lived assets.

(3) FASB Statement No. 121 provides sufficient guidance for the determination and measurement of impairment of internal-use computer software assets.

(4) As discussed in paragraph 45, technological feasibility does not appear to apply to internal-use commuter software assets. Additionally, there is sufficient guidance as to treatment of the assets should the project be abandoned.

(5) Costs as proposed by the SOP for capitalization are appropriate, except that I believe training costs included in the purchase price of purchased internal-use computer software assets should be included in the cost of asset, and depreciated over the life of the asset. Computer software is often complex and difficult to use, requiring training to be used effectively. The value of the software can be significantly diminished without proper training of staff. As such, it would appear that the training costs are more like equipment installation costs than lease executory costs, and should be included in the cost of the asset.

(6) The guidance for determination of whether computer software is for internal use appears sufficient and appropriate. I noted no instances where I would disagree with the proposed treatment.

(7) While allocation of costs between the internal-use software and the marketed software might be more theoretically correct, the cost of such allocation would probably outweigh any benefit. Additionally, the cost allocation would be at best an estimation, and methodologies for such allocations would probably be inconsistent between companies. I agree with the SOP's conclusions that allocation of costs is impractical, and that software for which there is an intent or plan to sell should be accounted for under FASB Statement No. 86.

(8) The definitions of upgrades, enhancements, and maintenance included in the SOP are adequate, and should be fairly easy to apply. Many companies have separate development and operations teams within their Information Technology departments. Upgrades and enhancements would probably be handled by the development team, while maintenance would be handled by the operations team. Absent the separate teams, or different individuals performing the different functions, project numbers would need to be assigned to upgrades and enhancements, and individuals would be required to track their time by project; however, this procedure is not significantly different from the procedure which would be required to initially track development costs, and should not be costly.

Please feel free to contact me if you would like to discuss any of my comments. I can be reached at (310) 618-0935.

Sincerely,

Sharon Vanzant

Sharon Vanzant

ıCIST. NUSSPICKEL, CPA PRESIDENT
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March 25, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Dear Mr. Noll:

We are pleased to submit our comments on the above-referenced proposed SOP on behalf of the New York State Society of Certified Public Accountants. The comments were developed by the Society's Financial Accounting Standards Committee.

The following relate to each of the issues raised in the letter accompanying the exposure draft.

Issue 1-The Committee agrees that computer software obtained from external sources should always be capitalized. Software developed internally should be capitalized only if there are appropriate records and internal controls to properly record such costs. The notes to the financial statements should disclose the accounting policy and the reason for non-capitalization in situations where such costs are expensed because of lack of records or controls.

The Committee feels that such a policy will allow entities to make cost/benefit decisions with regard to such projects. It was also influenced by the fact the SEC has had a number of enforcement actions against companies and their auditors where there has been inadequate documentation to support capitalization of soft assets.

Issue 2-The Committee agrees it is appropriate not to specify a maximum number of years for amortization. Flexibility is needed in this area and specifying a maximum number of years would probably lead to the use of the maximum as the normal life.

The Committee suggests the document should specifically point out what it already implies, that amortization could be based on something other than a straight line method.

Issue 3-The Committee agrees that SFAS No. 121 should be used to measure impairment. It suggests the document contain examples of different scenarios such as a change in the estimated life vs change in value, how upgrades in purchased software are handled, etc.

Issue 4-The Committee agrees with the position in the proposed SOP. The subject of technological feasibility is difficult and subject to wide interpretation.

Issues 5-8-The Committee has no comments.

We hope these comments will be helpful. If you wish to pursue further any of these Issues, please let us know and we will have someone from the Committee contact you.

Very truly yours,

William M. Stocker, III

William M. Stocker, III, CPA
Chair, Financial Accounting
Standards Committee

Walter M. Primoff

Walter M. Primoff, CPA
Director, Professional Programs

cc: Accounting and Auditing Committee Chairs

Ronald G. Nelson
Vice President and
Controller

3M General Offices

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3M

April 4, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Amercias
New York, NY 10036-8775

Re: File No. 4262
Exposure Draft, Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

3M is pleased to have the opportunity to express its views on this Exposure Draft.

We would like to make a few general comments before we comment on the specific issues in the Exposure Draft. In general, 3M supports the conclusions in the proposed SOP.

3M believes that flexibility should be allowed, potentially under the materially provision, to expense certain software projects. The expense option would allow the company to develop internal policies which would not create an undue administrative burden for computer software which was small in dollar magnitude or had a short useful life.

3M also supports the FASB Statement No. 121 impairment criteria, but cautions that impairment will be difficult to assess unless use of the software product is discontinued.

Lastly, the guidance for computer software activities that are upgrades or enhancements versus activities that are maintenance is not acceptable. Without more definitive guidance the AICPA will not reach its objective of gaining more consistency in practice. If this issue can not be resolved, the SOP should not be issued. How much maintenance will be required to keep the system viable? When is the system really done - if ever? Is this SOP symmetrical with the EITF guidance which states that year 2000 costs should be expensed?

More details on the issues identified in the ED are contained in Attachment I.

We appreciate the opportunity to provide input on this ED.

Sincerely,

RGNelson

Enclosure

Attachment
Mr. Daniel Noll, Technical Manager
April 4, 1997

<u>**Accounting for the Costs of Computer Software Developed or Obtained for Internal Use**</u>

Issue 1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting these costs as assets exceed the costs of such reporting? What are the costs of reporting?
Paragraphs 50-67 provide the basis for AcSEC's conclusions.

Yes, the costs of computer software developed or obtained for internal use should be recognized as an asset. An investment in software, similar to other long-lived assets (i.e. property, plant and equipment), will normally provide future benefits.

It is assumed that an organization would have the option of expensing some costs within the framework of materiality, as the provisions of this statement need not be applied to immaterial items. The materiality provision would allow the company to develop internal policies which would not create an undue administrative burden for computer software which was small in dollar magnitude or had a short useful life.

3M currently capitalizes major internal software projects which meet defined criteria. For major projects, the benefits of reporting these costs as assets clearly exceed the costs of reporting.

Issue 2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?
Paragraph 75 provides the basis for AcSEC's conclusions.

No, a maximum amortization period should not be specified. The statement in paragraph 30 that these costs should be amortized in a systematic and rational manner over the estimated useful life of the software is sufficient. However, there may be uncertainty as to the developer's ability to estimate the useful life.

No, the SOP should not require certain methods of amortization. If an amortization method other than straight line provides a better matching of the benefit received over the appropriate periods, the use of that method should be allowed.

Issue 3: Should impairment of internal use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?
Paragraphs 72-74 provide the basis for AcSEC's conclusions.

FASB Statement No. 121 should be the starting point for determining impairment. We realize impairment will be difficult, if not impossible, to measure in many cases; such as cash flow analysis and fair value determination for software that provides benefits to many areas within a company. In practice, 3M expects most internally developed software will remain as an asset until fully amortized, or until it is no longer being used.

Issue 4: The proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?
Paragraphs 44-49 provide the basis for AcSEC's conclusions.

No, an entity should not be required to meet technology feasibility criteria before capitalizing qualifying costs. The company agrees that these costs should be capitalized based on principles similar to those for long-lived assets.

Issue 5: Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?
Paragraph 68 provides the basis for AcSEC's conclusions.

The company agrees with the kinds of costs that should be capitalized as stated in this SOP. 3M believes that AcSEC should allow for the capitalization of variable overhead costs, consistent with the guidance for self-constructed fixed assets.

Issue 6: Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?
Paragraphs 38-43 provide the basis for AcSEC's conclusions.

Yes, there is sufficient guidance in the SOP to help entities determine if computer software is for internal use. This guidance is appropriate as stated.

Issue 7: Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?
Paragraphs 38-43 provide the basis for AcSEC's conclusions.

Yes, an entity should follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both. 3M agrees that in most cases it would be impractical to allocate costs between internal-use software and software to be marketed.

Issue 8: The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational? Paragraphs 63-64 provide the basis for AcSEC's conclusions.

No, the guidance for upgrades or enhancement versus maintenance is not operational. Without more definitive guidance the AICPA will not reach its objective of gaining more consistency in practice. If this issue can not be resolved, the SOP should not be issued. Examples of items which would fall under each category should be provided. If an item falls into a gray area a preference should be stated for capitalizing versus expensing. 3M's preference would be to state that if the change is not clearly recognizable as an upgrade or enhancement, it should be expensed.

Financial Institutions Accounting Committee

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Washington Mutual Savings
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Financial Managers Society
Chicago, Illinois

Dorsey L. Baskin
Arthur Andersen, LLP
Washington, D.C.

March 21, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
Accounting Standards Executive Committee
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The Financial Institutions Accounting Committee ("FIAC") is pleased to have the opportunity to respond to the exposure draft of the proposed Statement of Position ("SOP") on *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. FIAC is a group of 16 financial professionals working in executive level positions in the thrift and banking industries and is affiliated with the Financial Managers Society. The comments within this letter are representative of the FIAC as a whole and do not necessarily reflect individual views of the institutions represented on the Committee.

Summary

While our letter addresses the specific issues raised in the exposure draft, the FIAC agrees with concepts of capitalization of costs for the acquisition or development of software for use within a financial institution or other type of organization. We endorse the thrust of the proposed SOP because it will require institutions to capitalize costs and subsequently amortize those costs over a term which will match the economic benefits derived from the software. The SOP defines the asset which can be significant not only in regards to dollars but also in terms of importance to an institution. As technology grows, so too will the need to acquire or develop more technologically complex software and systems.

The scope of the SOP does not include costs of re-engineering operations or costs of converting data from old to new systems (paragraph 10). We believe expansion of the SOP to these areas would benefit many organizations due to frequency of occurrence and the association with development or acquisition of software. FIAC feels if this area is omitted, the industry will continue with inconsistent practices which this SOP aims to eliminate.

You requested comments regarding eight specific issues discussed in the proposed SOP. Our response to these issues along with the individual questions follows.

FMS
FINANCIAL MANAGERS SOCIETY
230 West Monroe · Suite 2205 · Chicago, Illinois 60606 · (312) 578-1300

Issue #1 - **Should the costs of computer software developed or obtained for internal use be recognized? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as an asset exceed the costs of such reporting? What are the costs of reporting?**

We support the establishment of an asset representing the costs of developing or obtaining computer software for internal use. We believe the costs which meet the criteria defined in the SOP should be required to be capitalized. The only exception which an entity can employ is where a company's policy for immaterial acquisitions allows for expensing. Currently, practice among many organizations is to expense acquisitions under a defined dollar amount because capitalization of small dollar amounts would incorporate costs of reporting exceeding the benefits of such reporting.

FIAC believes computer software meets the three essential characteristics of an asset as cited in FASB Concepts Statement No. 6. Additionally, computer software either developed or acquired should be capitalized when an entity can demonstrate a probable economic benefit and technological feasibility. We agree with the conclusion reached in paragraph 56; however, we believe the SOP should incorporate technical feasibility in the capitalization criteria as prescribed in SFAS #86 *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed.* FIAC believes having similar criteria will provide clarity to entities for capitalization of software costs.

Issue #2 - **Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?**

Management must use judgment in the estimated useful life of the software. FIAC agrees with the conclusion reached in paragraph 75. Due to the fact that technology changes rapidly, a life which is reasonably short or an estimated life that would fully amortize the cost until a system replacement is considered would be an appropriate life.

Amortization should begin once capitalization ceases and when the software is in use. The proposed SOP should recognize that there may exist a period of time between the completed testing and full implementation of the computer software.

<u>Issue #3</u> - **Should impairment of internal-use computer software assets be recognized and measured in accordance with SFAS No. 121 *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure impairment of internal-use computer software assets?**

Computer software which does not perform according to its intended use or developed incompletely has little or no value to an entity and therefore, should be carried at the lower-of-cost or fair value, less costs to dispose or sell. Can an entity ascertain fair value on internally developed software and, if not, does this require an entity to default to cost?

Impairment may occur when a "significant change occurs in the extent or manner in which the software is used" as noted in paragraph 28. For example, when a general ledger system is acquired which has a report writing module included and an entity intended to use the module for consolidating entities but subsequently changes its approach to use a more efficient PC-based system, this change does not indicate impairment. The entity may use the reporting module for other types of reporting and therefore, the portion of the system still has determinable value. If, on the other hand, the report writing module is totally disregarded and not used and the entity can reasonably determine the cost associated with the module, then one could argue that impairment or loss of value has occurred.

The proposed SOP indicates the possibility of impairment if "a significant change is made or will be made to the software program". FIAC does not necessarily agree that this indicates impairment. The SOP attempts to make a distinction between development and upgrades or enhancements as specified in paragraph 24. If changes are made to existing computer software, such as the addition of EDI for payment of invoices in an accounts payable system, the changes are typically made to improve the functionality of the software. The value of the previous version of the software has not declined. This inconsistency needs to be better defined.

FIAC believes another impairment standard is not necessary and that provisions of SFAS No. 121 are adequate in determining impairment.

<u>Issue #4</u> - **Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?**

As stated previously, FIAC believes that technological feasibility along with probable economic benefits must be identified for costs to qualify for capitalization. Software which is feasible of completing the tasks incorporated in its design should be an element in the asset. Costs incurred for software obtained or developed which is not technically feasible have little or no value.

Therefore, FIAC reiterates strongly its desire to have an entity meet technological feasibility as a criterion for capitalization of costs, provided these costs are not research and development.

Any costs incurred prior to establishing technological feasibility should be expensed.

<u>Issue #5</u> - Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Using incremental direct costs for capitalization is an approach which provides the least amount of subjectivity in the costs used for capitalization. When acquiring computer software "off the shelf" such as a spreadsheet program, the amount of costs capitalized include the purchase price and associated sales taxes and delivery charges (shipping and handling). Costs, such as the payroll and payroll taxes for the employee installing the software, would also qualify for capitalization under the provisions of the proposed SOP. Entities, however, will recognize the onerous and costly tasks of recordkeeping for such a process. The propensity for organizations will be to capitalize the direct purchase costs and expense the indirect installation costs due to their immateriality.

For computer software which is developed, FIAC concurs with the SOP that direct salaries and wages and payroll-related costs for the personnel involved in the project would qualify for capitalization. External costs for consultants, legal fees for contracts and other professional fees are also direct costs which logically would be included and qualified for capitalization. For example, if a consultant is hired to find a deposit system for an institution and the consultant arranges vendor presentations in response to an RFP, the charges incurred from the consultant would qualify for capitalization.

Although not included in paragraph 10 of the SOP, the scope should include the costs for conversion of *pre-existing* data from an old system to a new system which has been developed or acquired. For example, if a financial institution purchases or develops a document imaging system, the process of converting loan documents or cleared checks is significant and is an integral part of implementation. Likewise, if a new general ledger is purchased or developed, the transaction history is typically converted to the new system allowing for the institution to abandon the old system. The ultimate value of a system does not lie in the software alone but, more importantly in the data. The SOP should allow for companies to include the costs of converting old data or repopulating the new system in the capitalization.

Paragraph 16 of the proposed SOP denoted the various stages of computer software development; however, on the front-end of a development project when multiple alternatives are present, consideration should be given to allowing capitalization of costs incurred for the alternative chosen. For example, if several consultants are contacted to make presentations for a given project, and one consultant is hired to begin coding, can the costs incurred by the consultant chosen in the preliminary stage be capitalized? FIAC believes the direct costs should be capitalized while any other indirect costs incurred, such as those from other consultants, be expensed.

Distinction has not been made for the development of applications of given software from the actual software acquired. For example, if a software application is purchased, such as Clipper, and it's used to create an investor accounting system to handle the cash flows on municipal lease transactions, can these development costs incurred to create this "system" be capitalized? FIAC recognizes that the Clipper software, in this example, can be capitalized; however, the SOP is not clear regarding the additional development costs. Another example would include the creation of applications of "systems" from spreadsheet software such as Excel or Lotus 1-2-3. These applications definitely accrue benefits to the organization, but should these development costs be considered? FIAC concludes that these costs do qualify for capitalization because these applications have value to an organization. If a procedure is enhanced by the use of these applications, then capitalization should be allowed. In addition, the proposed SOP does not make mention of the associated documentation of the software or application of the software. Paragraph 10 should include this distinction as well. FIAC also recommends the cost of documentation be included as part of the capitalization process.

FIAC concurs with the capitalization of costs for upgrades and enhancement as denoted in paragraph 24.

Issue #6 - Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is the guidance appropriate? Why?

Paragraph 9 possesses the proper answers to this issue. FIAC concurs with the conclusions reached in paragraph 38, given the opportunity to apply these provisions to individual modules in the computer software. When the intent to sell exists, an entity should follow the provisions of SFAS No. 86 as stated in the SOP. We concur that it is impractical to allocate costs between internal-use software and software to be marketed.

Issue #7 - Software is sometimes developed or obtained for both internal use and external marketing. Some believe the costs should be allocated between internal-use and software to be marketed. Do you agree with this approach in the proposed SOP that requires an entity to follow guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should these costs be allocated?

Deferring revenue recognition until all costs of the software are recovered appears to be a reasonable approach. FIAC concurs with the conclusions reached in paragraph 40 citing that sufficient guidance is found in SFAS No. 86 and this proposed SOP.

Issue #8 - The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Using existing standards and practices for other types of capital assets should extend to computer software. Where significant functionality is added or significant improvements in the performance can be measured, then the additional costs should be capitalized. Costs for minor corrections to programming that have limited or immeasurable improvements in the performance or efficiency of the software should be considered maintenance and expensed when incurred.

Mr. Daniel Noll
March 21, 1997
Response to Exposure Draft
Proposed Statement of Position
Accounting for the Costs of Computer Software
Developed or Obtained for Internal Use

In conclusion, we appreciate the attempts by the AICPA to resolve inconsistencies currently in practice involving capitalization of software costs. Such consistency in reporting will help to minimize errors and inconsistencies, as fewer adjustments will be made.

Sincerely,

James W. Bean

James W. Bean, Jr.
Chairman

cc: Zane Blackburn, Office of Comptroller of the Currency
Gerald Edwards, Federal Reserve
Timothy Stier, Office of Thrift Supervision
Robert Storch, Federal Deposit Insurance Corporation
James Green, American Institute of Certified Public Accountants

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March 31, 1997

Daniel Noll
Technical Manager, Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Knoll:

We are pleased to submit the comments of the Standard Setting Subcommittee of the Accounting Principles and Auditing Standards Committee of the Connecticut Society of Certified Public Accountants on the Exposure Draft of a proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

The views expressed herein are those of the Subcommittee established to comment on proposed accounting and auditing standards. The views are not necessarily those of the Accounting Standards and Accounting Principles Committee or membership of the Society.

The comments of the Subcommittee are presented on the following pages in the order in which the "Areas Requiring Particular Attention by Respondents" section of the cover letter accompanying the proposed SOP and the issues are referred to using the numbers assigned in that section.

We appreciate the opportunity to present our comments. Should there be any questions, please feel free to contact Paul Rohan, CPA, Chairman of the Standard-Setting Subcommittee at (203) 401-2101.

Very truly yours,

Paul Rohan
Subcommittee Chair

David K. Christie
Subcommittee Member

Andrea J. Lavenburg
Subcommittee Member

Issue 1:
Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

Asset Recognition

We believe that the costs of computer software developed or obtained for internal use should be recognized as assets. We believe that because those costs meet the definition of an asset, have the essential characteristics of an asset, and meet the criteria for recognition as an item in the financial statements.

Option to Capitalize or Expense

We believe that the essential characteristic of an accounting standard is that it should limit diverse accounting practices and not endorse them. The ultimate failure of standard-setting is the issuance of an accounting standard that endorses diverse accounting treatments as acceptable options available to the preparer. Such standard-setting is misguided and does nothing but elevate to the level of generally accepted accounting principles the diverse accounting practices that were the source of the perceived problem at the onset of the project.

Those whose concern might be that the SOP will call for capitalizing costs that are not worth the effort should take comfort in the language contained in the block on page 17 of the proposed SOP following the standard which states "The provisions of this Statement need not be applied to immaterial items."

Cost Benefit Test

Paragraph 61 of the Basis for Conclusions of the SOP quotes from FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* which states "comparability between entities and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance." That benefit to those who are users of general purpose financial statements, one which is so difficult to characterize much less quantify, is what must be weighed against the estimable costs to preparers in making the information available. An additional cost consideration not commonly considered is that which is imposed on the users of the financial statement as a result of not providing information that otherwise would have been useful.

Costs of Reporting

The costs of recognizing computer software developed for internal use cannot be significant to most entities that follow that practice. The basic cost information should already be captured within most accounting systems. While there will be some costs associated with modifications necessary to further identify and capitalize eligible costs, the methodologies currently used to capitalize self-constructed assets could easily be modified for use with software developed for internal use.

Issue 2:
This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization ? If so, why, and what methods should be required?

Amortization Period

We do not believe that the SOP should not specify an amortization period. We are unaware of any reason to be more specific the period of amortization for software developed for internal use than for long-lived assets in general. Past experience with setting limits on the amortization of intangibles over a period not to exceed 40 years has had the effect of establishing the outer limit as the *de facto* standard, a condition that resulted in the need for an additional standard to limit abuses and set limits on core deposit intangibles acquired in a purchase.

Amortization Method

We do not believe that the SOP should specify an amortization method. The selection of amortization methods should be no more specific for software generated for internal use than for all depreciable and amortizable assets. While there may be merit to a future project addressing the larger issue of depreciation and amortization methods, that subject should not be addressed within the narrow perspective of the amortization of software developed for internal use.

Issue 3
Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of? If so, does the proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

Determination of Impairment

We believe that impairment of internal-use computer software assets should be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of.* We believe that Statement 121 provides a conceptually sound framework within which impairment can be assessed.

Impairment Guidance

As with many assets committed to management and administrative functions within an organization, there will be difficulties grouping internal-use computer software assets in a manner in which cash flows can be compared to asset values. That problem is inherent in the Statement 121 model for assets not directly associated with cash-providing activities, most of which must be assessed at the entity level. However, there is no need for more stringent impairment recognition tests for internal-use computer software assets than for executive office furniture or other assets committed principally to headquarters activities. More importantly, paragraph 29 of the SOP addresses software that has been abandoned and affords it the same treatment given to assets to be disposed of under Statement 121.

Issue 4:
The proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

Technological Feasibility

We believe that the proposed SOP, which requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development, makes the appropriate distinction between computer software assets that are produced for internal use versus those developed for future sale. We do not believe that there is a need for an entity to meet technological feasibility criteria before it begins capitalizing costs. In that regard, we believe that the proposed SOP makes effective use of existing literature which, since its evolution, has distinguished between internally generated software to be used by the entity and that which is developed to be sold, leased, or otherwise marketed. The former is no different than any other self-constructed long-lived asset whereas the latter is more like inventory. Accordingly, we believe the distinction made in the SOP is appropriate for the reasons cited in paragraphs 44 through 49 of the Basis for Conclusions of the proposed SOP.

Issue 5:
Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use software assets? Why? What costs should be included or excluded?

Costs to be Capitalized

We believe that the SOP has captured the essential components of cost to be capitalized and that further refinement of those costs may not be productive. We agree that for reasons of practicality, overhead costs have been excluded from those that are capitalizable. That reasoning is stated appropriately in the last sentence of paragraph 68 of the Basis for Conclusions:

AcSEC recognizes that the costs of some activities, such as allocated overhead, may be part of the overall cost of assets, but it excluded such costs because measurements of the amounts that should be allocated to computer software are too imprecise.

We do not, however, agree with the last phrase in the last sentence of paragraph 26 of the standard section which suggests a different reasoning for excluding costs including overhead:

General and administrative costs, overhead costs, and training costs should not be capitalized as costs of internal use software; those costs relate to the period in which they are incurred.

We believe that both the Conclusions section of the Statement and its Basis for Conclusions should contain the same reasoning for excluding overhead from capitalization. Further, to characterize overhead as a period cost and to then use that label as a reason for not capitalizing the cost is simply to argue by assertion that a prejudged conclusion is correct.

The misleading language of paragraph 23 is apparent when one considers that overhead must be capitalized into the inventory of a manufacturer. Interest is perhaps the foremost of period costs. It is by definition the simple product of time and rate. Yet, despite being a period cost, it is required to be capitalized under FASB Statement No. 34--and it is required to be capitalized under the proposed SOP.

Issue 6:
Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

Whether Software Is For Internal Use

We believe that the guidance in the SOP is sufficient to enable entities to determiner whether computer software is for internal use. Paragraph 11 of the proposed SOP contains language that is useful in making the necessary distinction. Further, the examples included in Appendix A of the SOP are helpful illustrations of that distinction.

Issue 7:
Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should costs be allocated?

Allocation of Software Developed for Internal Use and Software to be Marketed

We agree with AcSEC's conclusion that it is impractical to allocate costs between internal-use software and software to be marketed and agree with the reasoning for their conclusions as cited in paragraphs 38 through 43 of the Basis for Conclusions of the proposed SOP.

Issue 8:
The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Distinguishing Upgrades and Enhancements from Maintenance

We believe that the proposed SOP provides adequate operational guidance for making the distinction between activities that are upgrades or enhancements from those that are maintenance. Further, for computer software, there is considerably more guidance on making that distinction than there is for long-lived assets in general, and we do not believe that such guidance should be further expanded within the very narrow field of accounting for internal-use software.

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April 1, 1997

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Dan:

I wish to make comments on the AcSEC Exposure Draft, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." You may know that I write a research service for buy-side and sell-side analysts called The Analyst's Accounting Observer; I've enclosed a recent report that dealt with this exposure draft. In writing the report, I encountered a situation that I'm sure AcSEC confronted as well. I found that companies that follow a software capitalization policy generally make fair disclosures about amounts capitalized and amortized. At the other extreme, companies that expense software seemed to disclose very little about the dollar quantification of such a policy. Overall, the existing level of disclosures about capitalization policy made me unsure about how widely practice varies in regard to software capitalization.

Regardless of whether companies employ varying policies, the accounting in the Exposure Draft is a vast improvement over the existing accounting - which is none at all, or perhaps "folklore accounting" at best. Let me address several of the issues where the Exposure Draft requested comments:

(1) Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs?

The costs of such software should be recognized as assets. It makes little sense to treat such costs as expense; whether self-developed or purchased from outside vendors, these costs provide benefits that extend beyond the current accounting period of incurrence. Expensing them because they are self-developed makes as little sense as expensing a new grocery store because it was self-constructed.

Entities should not have the option to capitalize or expense such costs; this is the situation we currently have. If the costs of software fit the definition of an asset - and I believe they do - then current practice needs to be improved.

Because companies already account for such expenditures already as either assets or expense, the cost of uniform treatment should be minimal.

(2) Should the SOP specify a maximum amortization period or certain methods of amortization?

The SOP should not require specific maximum amortization periods or methods of amortization. These items might legitimately and justifiably vary widely from one firm to another.

What the SOP should require is clear disclosure of the amortization periods, amortization methods, and the effects of significant changes in them. This information would be far more useful to users than mandating "one-size-fits-all" amortization practices.

(3) Should impairment of internal-use computer software assets be recognized and measured in accordance with SFAS No. 121?

Yes, impairment should be based on SFAS No. 121. The guidance in the Exposure Draft is sufficient; however, one of the indicators in Paragraph 28 needs some revision. I would recommend that "A significant change is made or will be made to the software program" is far too vague to be useful. Changes are made to programs all the time; significance is in the eye of the beholder (or the auditor). Perhaps what was contemplated by AcSEC was "a change to the software that indicates it's no longer useful in its existing configuration."

(4) Should an entity be required to meet a technological feasibility criteria before it begins capitalizing qualifying costs?

No. The model that the software accounting is following in this exposure draft is accounting for long-term assets, whether self-constructed or purchased. The criteria of that model are sufficiently espoused in paragraphs 21 through 25, and they embody an implied feasibility criteria. (Internal-use software systems are not ground-breaking applications. If an internal-use software project seemed to be a low-probability affair, would management commit to it? See paragraph 20.)

To require technological feasibility criteria similar to SFAS No. 86 would be mixing models: the technological feasibility requirements of SFAS No. 86 relate to inventory costs, not long-lived asset costs.

(5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets?

The proposed SOP is neither too broad or narrow in its definition of capitalizable costs. There is one area that AcSEC might want to note: the Exposure Draft permits capitalization of payroll and payroll-related costs of employees directly associated with a software project, but makes no mention of their indirect costs (light, power, office facilities, etc.). I believe that indirect costs of such personnel are capitalized in practice for SFAS No. 86, though it didn't really permit or deny such treatment. If differences in these capitalizable costs arise between the two pronouncements, it's hard to justify it on the grounds that they espouse different cost models as discussed in (4).

AcSEC may wish to strive for uniformity with SFAS No. 86 in this regard - or more explicitly state reasons for not allowing capitalization of such amounts.

(6) Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use?

Yes, the guidance in the proposed SOP is sufficient.

(7) For software that is developed or obtained for both internal use and external use, is the approach in this SOP which requires that an entity follow either the SFAS No. 86 approach or the accounting detailed in the SOP?

The "one-or-the-other" approach is satisfactory. What needs to be developed is how firms should account for changes from one approach to the other. Suppose a firm is developing a software product for sale under SFAS No. 86 for the first three quarters of the year, but changes course and decides not to develop it for sale to outsiders in the fourth quarter - and also decides to pursue a capitalization policy? Would they need to restate the first three quarters? What disclosures would be needed in the fourth quarter? These issues are more problematic to me than an initial "either-or" selection.

One aspect of the exposure draft that was not addressed in the "issues" section was transition. I am concerned that there are no requirements that require the disclosure of the effect of switching from an expense policy to a capitalization policy; the transition is effectively handled on a prospective basis.

While I have no problem with the prospective treatment, I have serious reservations about the lack of disclosure of the favorable effects of such a change. Such a change in policy could be an earnings booster, giving the appearance of earnings improvement without anything really new occurring in the workings of a firm. There has been adequate disclosure in the past when a change in accounting principle had a negative effect on earnings - recall SFAS No. 106. When the effect of an accounting change is favorable, there should be equivalent disclosure of the change's effect *directly on the face of the income statement and in earnings per share.*

I also believe that specific disclosures should at least be exemplified in the SOP. I realize that no new disclosures are required, and that any disclosures should be made in accordance with existing authoritative literature. There is, however, nothing in the authoritative literature that speaks to capitalization of software costs in this manner, and I believe that without some kind of specific requirement - or at least a couple of examples - poor practice may result. There needs to be more attention paid to disclosures than mere cross-referencing. Given that the proposed treatment "liberalizes" income recognition, users will depend heavily on disclosures for indications of abusive accounting. That's why it's so important to specify disclosures. Some suggestions:

- Beginning amount of capitalized software.
- Amount capitalized in each year.
- Amount of amortization and accumulated amortization.
- Ending amount of capitalized software.
- Amount of software writedowns and rationale for writedowns.
- Description of capitalization policy, including kinds of costs capitalized.
- Changes in capitalization policy, and net income effect of changes.

Those are my comments. Overall, I think AcSEC has made a fine exposure draft and the Committee has done well in its attempts to improve financial reporting. If you have any questions about my comments or about the enclosed report, don't hesitate to call. Best regards.

Sincerely,

Jack T. Ciesielski

Jack T. Ciesielski

Volume 6, No. 3 *February 20, 1997*

Synchronizing Software Policies: AICPA's Proposed Rules

Article not reproduced in Web version

It's inconceivable that a modern company could run very efficiently - if at all - without some significant investment in a management information system. Software has become an integrated part of what makes a firm's business run: witness the rise of just-in-time inventory systems and automatic inventory replenishment systems.

Software to run a firm's business can be expensive, whether it's purchased "off-the-shelf" or developed internally by a firm, and it certainly provides benefits for years to come. Yet there are differing accounting practices regarding the cost of software employed by firms. Many companies will capitalize the cost of software developed or obtained for internal use, and subsequently amortize such costs against earnings; others prefer to treat such outlays as a normal recurring business expense.

The Accounting Standards Executive Committee of the American Institute of CPAs has released an exposure draft of a Statement of Position which would settle once and for all the classification of these expenditures. It could be effective as early as next year - and would provide an earnings boost to some companies while widening the gap between their net income and cash flow from operations.

I. Is It An Asset Or An Expense?

Imagine a wholesaler of grocery products constructs a new, state-of-the-art distribution center in order to service retail clients in a particular region. Brick and mortar facility costs incurred over two years total $30 million - a hefty sum for our fictional wholesaler. That $30 million expenditure allows the wholesaler to service customers for the next twenty years - in other words, after its

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Companies in this report:
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March 31, 1997

Daniel Noll, Technical Manager
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American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Daniel:

RE: AICPA Exposure Draft - Proposed Statement of Position - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use - December 17, 1996

The Arkansas Society of Certified Public Accountants' response to the exposure draft referenced above is as follows:

"Software usually has a very short economic life. The SOP should specify a maximum length of time for amortization of costs 5 years."

Sincerely,

Barbara

Barbara S. Angel
Executive Director

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April 8, 1997

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Subject: Proposed Statement of Position - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

The Financial Reporting Committee of the Institute of Management Accountants is pleased to offer its comments to the exposure draft of the subject matter. In addition to providing specific responses to the issues on which specific comments were requested, we would offer our overall support for this proposed statement of position ("SOP").

The proposed SOP brings more practical application to the difference between research and development expense versus capitalizable expense than FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed ("FAS 86"). The disparity in capitalization among software companies today in applying the FAS 86 standard indicates there is substantial latitude in applying the tests under such standard. Software development tools and methodologies have changed significantly since the issuance of FAS 86 and the standard is very difficult to apply in today's environment. This proposed SOP establishes a more practical approach to determining when capitalization is appropriate in a software development process.

The proposed SOP will not only provide for capitalization of many projects which have been expensed in the past, but also will become the new standard for capitalization. With much of corporate America continuing to outsource elements of their businesses where others provide superior product and lower price, service industries continue to thrive and grow. These industries use a substantial amount of computer software which, in some instances, in practice, was considered "software ... otherwise marketed as part of a product or process" as defined in paragraph 2 of FAS 86. We agree with the proposed SOP that defines such computer software as internal use software and, therefore, under the guidance of the proposed SOP.

In order to allow procedures to be developed and systems designed and implemented by companies unable to presently fulfill the requirements of

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the proposed SOP, we recommend the effective date be extended one year while still encouraging early implementation.

All other comments that we are making with regard to this proposed SOP are covered in our responses to the specific questions that you posed. These questions and our responses follow:

Question 1:

Should the costs of computer software developed or obtained for internal use be recognized as assets?

Yes.

Should entities have the option to capitalize or expense such costs?

No.

Do the benefits of reporting those costs as assets exceed the costs of such reporting?

Yes. If the amount is not significant to the organization, the effect of non compliance with this proposed statement would not be material. If the amount is significant to the organization, project management systems should already establish and track the direct costs expended on such projects as part of the operating process. However, it should be recognized that certain systems may not provide the necessary information to make balance sheet entries and this proposed SOP may represent substantive additional costs to the organization.

What are the costs of reporting?

This will differ from organization to organization based on the nature of the effectiveness of the project management system in capturing the direct hours expended internally on the project as well as direct outside costs.

Question 2:

The proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why and what maximum period should be specified?

Providing a specific maximum period would replace judgment with a specific number of years, a practice that has not been the focus of accounting principles in the past. This proposed SOP applies to various types of software, such as back office financial applications and software directly generating revenue. This software will have widely disparate need for periodic replacement and, thus, a wide range of estimated useful lives.

Furthermore, software technology has undergone significant change in the past decade and software has a different average life today than it had ten years ago. Future changes are expected to occur which may either shorten or lengthen software lives as more open architectures increase transportability of software, while newer hardware provides additional functionality and the need for new software. Therefore, establishing a maximum life would require periodic updating. For these reasons, establishing a maximum period is inappropriate.

Should the SOP require certain methods of amortization? If so, why and what methods should be required?

There is a difference between this proposed SOP and FAS 86. FAS 86 requires amortization of the greater of (i) an amount which is amortized relative to expected revenues and (ii) straight line. This SOP simply requires a systematic and rational method. Therefore, a company that develops and sells software and a company that develops the same software but "sells" it as part of a service offering may be faced with different accounting methods. The SOP is the more logical and preferable choice between the two approaches as it places the responsibility on management to use a proper method; however, it is appropriate to note its inconsistency with FAS 86 especially since many companies which have capitalized in the past under FAS 86 would now have new projects of a similar type being capitalized instead under this SOP.

Question 3:

Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

FAS 121 should apply where it is appropriate. However, this proposed SOP does not provide adequate guidance. It would appear there are at least two types of software capitalizations that would occur under this SOP, each of which appears to create a different issue in applying FAS 121:

(i) Certain capitalized software directly leads to revenue generation, either by providing service revenues or as an integral part of a process producing a specific product for sale. In these instances, the measurement of profit related to such revenues would form the basis for a cost recovery review of the asset for impairment measurement purposes.

(ii) Other capitalization relates to the overall business, such as accounts payable or management information reporting systems. These items are a basic part of the ongoing business. Impairment measurement would be analogous in these instances to determining impairment for the corporate office building.

Question 4:

This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? Is so, what are those criteria?

In today's world of software technology and development methods, technological feasibility as defined in FAS 86 is an outdated set of terms. While FAS 86 offered two methods to establish such feasibility, neither appropriately addresses the issue in many cases. Examples exist today of major software companies which capitalize no software using the FAS 86 requirements to support the position that technological feasibility is not achieved, in essence, until the final product is produced. Others choose to capitalize no software because their process is not conducive to meeting the FAS 86 technological feasibility criteria. On the opposite side of the fence, companies which provide data processing services today have capitalized software under FAS 86, viewing such software as "otherwise marketed as part of a product or process, whether internally developed and produced or purchased". Under this proposed SOP, these data processing companies would now capitalize costs using the proposed SOP. Considering the above disparities under FAS 86 compliance, extending FAS 86 methodologies to the proposed SOP is not advisable. This proposed SOP, while not using technological feasibility, does establish some practical standards for determining when it is appropriate to begin capitalization.

Question 5:

Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

The proposed SOP properly limits capitalization to direct costs for materials, services and employees and excludes administrative and overhead costs. The capitalization of interest costs, while supportable as a concept for long-lived assets that can have a long development cycle, appears to be beyond the type of cost which users of financial statements would expect to be capitalized. Where capitalizing financing costs of a building during construction is very clearly demonstrable, interest cost related to payroll and other direct costs (versus the use of the company's equity) appears analogous to overhead costs which are not capitalizable under the proposed SOP. For this reason, if

AcSEC can conclude that not capitalizing is not in conflict with FAS 34, we would recommend that capitalization of interest be prohibited.

Question 6:

Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

The proposed SOP does provide appropriate guidance through Appendix A. Any responses to this exposure draft that indicate further guidance is needed should be addressed by appropriate additions or modifications to such appendix.

Question 7:

Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both?

Yes.

Question 8:

The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Yes.

******

We would be pleased to discuss our comments with you or your staff.

Sincerely,

Hal Rogero /LB

L. Hal Rogero, Jr.
Chairman

Union Camp
CORPORATION

J.F. Haren,
Controller

1600 VALLEY ROAD, WAYNE, N.J. 07470 TELEPHONE 201-628-2384

April 4, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Sixth Avenue
New York, NY 10036-8775

Dear Sir:

We appreciate the opportunity to comment on the exposure draft of the proposed statement of position on the topic Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. In general we applaud the attention being given to the need to recognize the value of an element of intellectual capital that will provide benefits in future periods as this proposal does. Issuance of the statement would be another important step in the efforts of rule-making bodies to ensure greater comparability in accounting by entities.

We offer the following comments on questions to which the Accounting Standards Executive Committee requested replies:

1. We agree that the costs of computer software developed or obtained for internal use should be recognized as assets. The key is whether they are expected to provide economic benefit in future periods. No distinction should be made between purchased software and internally developed software. Only the expected future benefit should determine whether or not costs incurred represent an asset.

2. We agree that the statement should not specify a maximum period for amortization or methods of amortization. We are concerned that a maximum period, if established, might become the standard. We believe that it is preferable that management exercise judgment in this regard, much as is done with a variety of other accounting estimates. 61

3. We agree with the Committee's specification of the kinds of costs that should be capitalized. The proposed statement recognizes the major elements of cost that contribute to the development of a useful asset while conservatively omitting other categories of costs such as overhead for which allocations to software development projects would be too arbitrary and, in our opinion, not relevant.

4. It is important to distinguish between software activities that are upgrades or enhancements and those that are maintenance. The clarification regarding modification of software for the year 2000 as described in the footnote to paragraph 24 is an important one.

Paragraph 10 states that accounting for costs of reengineering operations is not included within the scope of the statement. We believe it would be beneficial if the final document included a statement to the effect that such activities are an ongoing responsibility of management and that related costs, therefore, should be charged against operations as incurred.

Sincerely,

J. F. Haren

John F. Haren
Controller

JFH:egk

Lucent Technologies
Bell Labs Innovations

James S. Lusk, CPA
Vice President & Controller

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April 4, 1997

American Institute of Certified Public Accountants
Attention: Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Accounting for The Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

Lucent Technologies Inc. (Lucent) is pleased to submit its comments on the American Institute of Certified Public Accountants' ("AICPA") Proposed Statement of Position entitled *Accounting for The Costs of Computer Software Developed or Obtained for Internal Use* (the "Exposure Draft"). Lucent is one of the world's leading designers, developers and manufacturers of telecommunications systems, software and products. Lucent had total assets of approximately $23 billion as of September 30, 1996 and total revenues of $23.3 billion for the twelve month period then ended.

On an overall basis, Lucent is not supportive of the issuance of a final Statement of Position based on the Exposure Draft as presented in its current form. Lucent appreciates the AICPA's effort in tackling this difficult issue and supports fully the need to establish authoritative guidance to eliminate diversity in practice. The result, however, is an Exposure Draft with conceptual merit but with uncertain benefits and substantial implementation concerns.

By requiring the capitalization of eligible costs, Lucent believes that the AICPA has taken an overly liberal stance on this software cost recognition issue. On the surface, computer software costs for internal use seem to meet the characteristics of an asset as specified in Statement of Financial Accounting Concepts No. 6 ("SFAC 6"). However, while the capitalization of internal use software costs appears to have conceptual merit, there is a clear distinction between "soft," intangible assets and tangible assets. Tangible assets typically have predictable lives and a relatively high degree of certainty regarding future economic benefits. This is not necessarily true for intangible assets. In the specific case of internal use software costs, the threat of obsolescence makes their future economic benefits significantly more uncertain than those of tangible assets and their linkage to related cash flows in future periods is arbitrary.

There is also a clear distinction between software costs for internal use and software costs that are capitalized under FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* ("Statement 86"). Software costs under Statement 86 must pass stringent technological feasibility criteria and are tightly linked with future revenue streams. Software costs for internal use, particularly the costs of internally developed software, carry more risk and are not closely linked with future revenue streams.

Lucent finds the guidance in paragraph 148 of SFAC 6 to be persuasive. That source indicates that certain costs are properly recognized immediately as period costs when other periods to which they may otherwise relate are indeterminable or impractical to determine. We believe that internal use software fits in that category. Today, Lucent expenses all costs associated with internal use software, except for purchased operating system software which enables the hardware to function. We believe that immediate expense recognition is prudent given the speed of technological change, uncertainties in the realization of future economic benefits, and cost/benefit concerns. Alternatively, we could accept standards that require expensing the costs of internal use software developed internally while also requiring the capitalization of costs of purchased software. (Purchased software carries somewhat less risk and uncertainty regarding future economic benefits.)

Because of this uncertainty as to the realization of future benefits, i.e., the possibility of early obsolescence, coupled with implementation concerns (e.g., the need to introduce expensive cost accumulation mechanisms), Lucent does not support this Exposure Draft.

If the AICPA ultimately decides to issue a Statement of Position based on the Exposure Draft, we would like to offer the following comments/suggestions for your consideration:

- The Exposure Draft provides that capitalization of costs should begin once an entity has completed the R&D phase (i.e., the "preliminary project phase") and will end when substantially all testing is completed. This is significantly different than the start and stop points stipulated in Statement 86 and would result in more costs being capitalized for internal use projects versus those that will be externally marketed.

  Under Statement 86, the FASB took a conservative position when it required that all coding and testing activities be completed before an entity determines that the software project is technologically feasible. Although the technological feasibility concept is somewhat different under Statement 86 compared to internal use projects, the development process is largely the same. In fact, it can be argued that there is additional risk associated with internal development projects (e. g., migrating from a centralized, mainframe general ledger system to a distributed, client server architecture) compared to the development of a software product to be marketed. Therefore, at a minimum, a similar degree of conservatism should be applied to the internal development costs of internal use software. Put simply, costs should not be capitalized if they are incurred prior to the point when the feasibility of the software's use has been firmly established.

- We note that the Exposure draft does not address the costs of reengineering operations or the costs of data conversion from old systems to new systems. Reengineering costs can be very substantial and could include hardware/software infrastructure costs in direct support of project developers, and process reengineering costs that would not have been undertaken absent the internal use software development project. Data conversion costs can take many forms. Querying historical data in a general ledger system or reformatting/designating an existing account code structure into a new environment represent two different types of conversions that may require different accounting treatment. Depending on relevant facts and circumstances, reengineering and data conversion costs can be viewed as integral parts of the development project and would seem to be eligible for capitalization within the program instruction stage. Accounting for the costs of reengineering operations and data conversion should be addressed within the scope of this Exposure Draft.

- The Exposure Draft prescribes that impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* If capitalized under this Exposure Draft, Lucent concurs that internal use computer software is a long-lived asset covered by FASB Statement No. 121. However, these costs are somewhat different from the cost of typical, tangible long-lived assets addressed in Statement No. 121. Contrary to software to be marketed externally, an assessment of impairment will be extremely difficult because there would not be any identifiable cash flows for specific internal use software assets. Accordingly, impairment judgments would appear to be required at a much higher level, e.g., at an operating unit basis, resulting in less frequent software write-offs. We don't believe that result is appropriate. This concern would be mitigated to some extent if internal use software could not be capitalized until its technological feasibility had first been established. Lucent recommends strongly that guidance for determining impairment of internal use software be provided to avoid implementation problems.

- For purchased software, the Exposure Draft requires companies to estimate the amount of the total cost attributable to training and maintenance components and to exclude those amounts from capitalized cost. While this allocation concept is consistent with the proposed Exposure Draft on Software Revenue Recognition, the method is not the same. This Exposure Draft requires entities to estimate such costs (presumably at management's discretion) while the Exposure Draft on Software Revenue Recognition requires the allocation of revenue to be based on the fair market value of each element. Additional guidance in this area is required to avoid inconsistent applications of the principles in this Exposure Draft.

Finally, comments were specifically requested on certain issues raised in the Exposure Draft. While many of these issues were covered earlier, the following are responses to those remaining issues that we have not specifically addressed:

- Should the SOP specify that amortization should not exceed a maximum period?
  No. Although it may seem reasonable to place some limitation on the amortization period, Lucent believes that this is an area that can be addressed more appropriately by management judgment.

- Should the SOP require certain methods of amortization?
  Keeping things simple, guidance could be provided as follows: "Capitalized software costs should be amortized on a straight line basis, unless some other method is <u>clearly</u> more appropriate."

- Does the SOP provide specific guidance to help entities determine whether computer software is for internal use?
  Yes. The guidance is sufficient and the examples are helpful.

- Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or SFAS 86, but not both?
  Yes. The guidance is relatively clear and will avoid the complexity and cost associated with allocating the costs of individual projects between internal use software and software to be marketed.

- Is the SOP guidance operational that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance?
  Yes. The guidance is clear and operational.

In summary, we agree that there is a need to establish uniformity with regard to financial reporting of computer software costs for internal use. However, due to the typical high degree of difficulty attributable to being able to attribute future economic benefits associated with internal use software, we believe that the more appropriate treatment is to expense the costs of all internal use software. We appreciate your consideration of the points discussed in this comment letter. If you need any clarification, please feel free to call me at (908) 582-8560 or Joseph Yospe at (908) 559-8094.

Thank you for your consideration of our comments.

Sincerely,

James S. Lusk
Vice President & Controller

Marc D. Oken
Chief Accounting Officer

NationsBank

NationsBank Corporation
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NC1 007-5704
Charlotte, NC 28255
704/386-8676

April 1, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

We appreciate the opportunity to comment on the exposure draft "Accounting For The Costs Of Computer Software Developed Or Obtained For Internal Use" (the "proposed SOP"). We are the nation's fourth largest banking institution with assets of approximately $227 billion. In the last five years, we have invested at least $750,000,000 in computer software both developed internally and purchased from third parties. We will continue to make significant investments in information technologies, including computer software, as we build the nation's preeminent banking company by creating and acquiring new tools to more effectively and efficiently deliver our products and services to our customers.

We object to the proposed SOP's requirement that the costs of computer software developed for internal use be recognized as assets. We believe computer software developed internally or custom developed externally has a relatively short, indeterminate life due to the rapid pace of change in computer hardware and software technology and the rapid pace of change in products, services, competition, government regulation, and even accounting standards. We also believe it is difficult, impractical, and sometimes impossible to distinguish between and separately account for elements of a software project that are research and development or maintenance related versus the creation of new functionality. Finally, we believe the costs of recognizing these assets, amortizing them, and evaluating their possible impairment will exceed the value of any benefits that may be perceived.

Specific comments on issues as requested in the exposure draft are attached in the appendix to this letter.

We would be happy to discuss our views on this subject. If you wish to do so, call Karin Hirtler-Garvey (704/388-3554) or Avery Munnings (704/388-6705), in our Accounting Policy group.

Sincerely,

Marc Oken

Marc D. Oken

Appendix

Accounting For The Costs Of Computer Software Developed Or Obtained For Internal Use

Comments on specific issues:

1. We do not believe the costs of developing or modifying software for internal use should be recognized as assets, whether the work is done internally or by external contractors or vendors. However, we believe the costs of purchasing off-the-shelf, commercially available software could be recognized as assets, just as we recognize as assets the costs of purchasing items of computer hardware with similar costs and utility.

We believe that every software development project includes an element of research and development, and that every software modification project includes an element of maintenance. Those elements may be a large part of the project. These elements should clearly be expensed as incurred. However, isolating those elements and separately identifying the associated costs is extremely subjective and often difficult, expensive, and sometimes impractical.

We do not believe capitalization of software development or modification should be optional.

We believe the benefits of reporting costs of developing or modifying software are both small and of short duration while the costs of the reporting are relatively high. The reporting costs include the cost of keeping records of time spent on the project by various individuals, not all of whom are totally dedicated to a single project, and the allocation of salary and related costs based on each individual's time and compensation rate. Since many software modification projects are combined with maintenance activities and the mix of costs range from nearly 100% maintenance to nearly 100% new functionality or extended life, capitalization of only the cost of new functionality or extended life will require capture and tracking of costs at a sufficient level of detail to identify either maintenance components or improvement components. We believe that required investments in new project tracking systems combined with personnel and administrative burdens associated with the cost accounting required do not justify the benefits to be obtained when considering the short-lived nature of computer software.

The benefit to a statement reader in knowing the amount of software assets on the books is questionable especially since that information gives no insight into the quality, utility, or efficiency of that software.

2. We believe that amortization should be over the expected useful life of the software, using any of the methods commonly used to amortize or depreciate comparable assets, such as furniture and equipment. We believe that the determination of expected useful life requires the exercise of judgment, and the result will vary between software packages depending on a number of factors. Companies with similar software are likely to determine different lives. Likewise, the choice of amortization method may vary depending on the expected pattern of utilization or other factors that support a particular pattern of expense recognition. We do not believe it appropriate to impose an arbitrary limit on amortization period or to arbitrarily impose a particular amortization method. It is this very subjectivity that makes us oppose imposition of particular amortization periods or methods.

3. Unless a company has decided to take actions which may indicate impairment of particular software, Statement 121 is ineffective in dealing with impairment of software assets. The estimation of future cash flows, as required by paragraph 6 of SFAS 121, requires combining the software asset with an often-large number of other assets in order to reach a level at which the cash flows from the group of assets is independent of the cash flows of other assets. In our case, we are seldom able to do this at a level lower than the entire asset group supporting a particular product or group of products. In many cases, several products or groups of products share the use of a large number of assets, including software, making it impossible to isolate cash flows of an asset group even at the product or product group level. The result is that SFAS 121 is unlikely to require a write-down of any of the assets that are used to support one product or group of products unless the product or product group is projected to be unprofitable over the long haul.

If we did determine that a software impairment had occurred, based on the comparison of expected future cash flows with carrying value of the asset, paragraph 7 of SFAS 121 requires write-down to fair value. However, fair value, as defined in paragraph 7, may be the price at which the software could be purchased currently, which often exceeds the carrying value of the asset.

As a result, strict application of SFAS 121 would seldom if ever cause us to write down a software asset.

We also believe that the proliferation of software assets that would result from the proposed capitalization of all internal-use software would make it difficult to determine whether or not all the software continues to be used, and to have utility at least equal to that previously expected. As a result, impairment of unused or underutilized software may not be detected.

We believe that it is better to expense the software development and modification projects than to place assets on the books that may not be charged to expense at a pace that at least matches their loss of utility. We also believe that, if these assets are required to be recognized, a specific procedure for evaluating and recognizing impairment for this type of asset should be specified. We believe that procedure should be based on the reduction in expected life, level of utilization, or effectiveness compared to the original expectations. It should result in a write-off of a portion of the carrying value proportional to the reduction in expected future benefits.

We believe that many software modification projects result in the impairment of assets that this SOP would have required to be recognized due to earlier software development or modification projects. Many of the modifications remove or replace functionality that was a part of an earlier software development or modification project resulting in no further future benefits resulting from the original cost of that portion of the earlier software project. We believe the most practical way of addressing this is not to require recognition of assets resulting from internal use software development or modification projects. At a minimum, we should not be <u>required</u> to recognize new assets resulting from software modification projects that remove or replace functionality of earlier versions of the software, even if those projects add other functionality or extend the life of the software.

4. We agree with the limits on the beginning and end of cost capitalization specified in paragraphs 20, 22, and 23 of the SOP.

5. We object to the inclusion of interest costs, except where there is a specific borrowing to provide funding for a specific software project. Imputing interest cost for routine software projects would be cumbersome and misleading. Further, the capitalization of interest on routine software projects is inconsistent with the guidance in paragraph 10 of SFAS No. 34, "Capitalization of Interest Cost", as amended.

We believe that the identification of payroll and payroll-related costs that are incurred only for the portions of a software project that provides increased functionality or longer life, and do not include maintenance activities, will be cumbersome, highly subjective, and subject to abuse.

We agree with the exclusion of general and administrative costs and overhead.

6. We believe the guidance in paragraphs 11-15 and Appendix A is appropriate and sufficient, and agree with AcSEC's basis for so concluding.

7. We agree with the approach in the proposed SOP, but disagree with the content of the guidance if the proposed SOP is applied.

8. The guidance on distinguishing between upgrades and maintenance is very general, but clear. However, we believe that in practice it is very difficult to isolate those activities that produce extended life, new functionality, or other increased utility from those that merely keep the software up to date and correct errors. Elements of both are present in virtually every project. We also believe it is difficult to make accurate allocations of the project cost between the upgrade/enhancement element and the maintenance element.

WMX Technologies, Inc.

3003 Butterfield Road
Oak Brook, IL 60521

Phone 708.572.8800

Thomas C. Hau
Vice President and Controller

April 7, 1997

Mr. Daniel J. Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 4262, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Sir:

We appreciate the opportunity to comment on the proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (the "SOP"). We believe the SOP is conceptually sound and that its issuance will improve consistency and comparability in the accounting and disclosure of what is becoming an increasingly important asset for most companies. We support its issuance in accordance with the Exposure Draft.

Our response to each of the eight issues included in the covering memorandum are contained on the following pages. We appreciate the opportunity to comment on the Exposure Draft and the AICPA's consideration of our views.

Very truly yours,

WMX TECHNOLOGIES, INC.

Thomas C. Hau

Thomas C. Hau
Vice President & Controller

TCH/ph

Printed on recycled paper

Attachment to WMX Technologies, Inc. Comment Letter dated April 7, 1997

QUESTION 1: *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the cost of such reporting? What are the costs of reporting?*

RESPONSE: We believe that computer software developed or obtained for internal use should be recognized as assets. We believe such accounting should be required and not optional for the reasons set forth in paragraph 60. We believe that little or no incremental cost will be incurred in implementing the SOP as large software development projects are likely already controlled by a project cost accounting system and thus the information will already be available. Items below the scope which would require tracking through a project management system would likely be immaterial and would be expensed under the SOP.

QUESTION 2: *The proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

RESPONSE: We agree with the conclusions of paragraph 75. As with any other fixed asset, the company is in the best position to determine the useful life and the method of amortization which best fit its own circumstances.

QUESTION 3: *Should impairment of internal use computer software assets be recognized and measured in accordance with FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of"? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal use computer software assets?*

RESPONSE: Since FASB Statement No. 121 is the only impairment guidance currently in the authoritative literature, we support its use in determining impairment for computer software as with other long-lived assets. Measuring impairment of an asset with no directly related cash flow will require substantial judgment, but the conceptual approach is valid.

QUESTION 4: *Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

RESPONSE: We agree that technological feasibility is a concept appropriate to an inventory model and should not be applicable to the SOP. There is presumably an inherent benchmark in the development of internal use software that will result in management's abandoning a project and expensing any costs incurred if it is concluded that the software will not achieve the desired result.

QUESTION 5: *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal use computer software assets? Why? What costs should be included or excluded?*

RESPONSE: While there may be some costs that would effectively be capitalized in the case of purchased software, because they would be implicitly included in the purchase price, but excluded under the guidance of the SOP, we do not believe that this is a significant flaw in the proposed SOP. We believe the proposed SOP appropriately sets forth the types of costs to be capitalized.

QUESTION 6 : Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

RESPONSE: We believe the guidance in the proposed SOP is sufficient, particularly considering the examples provided in Appendix A. For most entities, we do not see this as a difficult call. The provisions of paragraph 33 and the requirements of paragraphs 11 through 14 (see Question 7 below) should be helpful in mitigating the impact of any inconsistency between entities in this area.

QUESTION 7: *Do you agree with the approach in the proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

RESPONSE: We agree that an entity should follow the guidance in either the SOP or the FASB Statement, but not both.. This is consistent with the differing objectives of the two documents. Again, we believe that the requirements of paragraph 33 will mitigate any differences and that the proposed SOP is considerably more practical than a requirement to allocate costs between software that is both used internally and marketed externally.

QUESTION 8: *Is the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance, as provided by the SOP, operational?*

RESPONSE: We believe that the guidance provided by the SOP is sufficient. For most entities, we do not believe that this distinction will be any more difficult than distinguishing between capitalized repairs and ordinary maintenance for any other long-lived asset.

....

In addition to our response to the foregoing questions, we wish to acknowledge with thanks the provisions of paragraph 34 that the SOP does not require any new disclosure.

Author: MIME:Mike_Kolesar@gigaweb.com at INTERNET
Date: 4/11/97 4:41 PM
Priority: Normal
TO: Daniel J. Noll at AICPA3
Subject: Re: Internal Use Software

------------------------------------ Message Contents ------------------------------------

Enclosed is my letter of comment. The enclosed file was originally prepared
in
Word 7.0 for Windows 95 and this version has been saved as a Word Perfect 5.1
for Windows 3.1. I hope that some of the formatting is not lost in the
traslation and transmission. I will send hard copy through the regular mail
if
you desire it. Please advise at your convenience.

Sincerely,
Michael J. Kolesar

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April 11, 1997

Mr. Daniel Noll
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File 4262
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Dear Mr. Noll:

I would like to thank you, the AICPA, and the Accounting Standards Executive Committee for the opportunity to submit some comments on the proposed Statement of Position ("SOP") *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs?

I believe that computer software should qualify for recognition as an asset, but entities should have the option to capitalize or expense such costs. As the document indicates in the **Introduction and Background**, over the last few years diverse practices have evolved. Existing requirements regarding disclosure of accounting policies would appear to have required entities to include this in their financial statements, but it appears that very few do. I believe that maintaining the consistency of an entity's prior practice and requiring disclosure of its policy is preferable to requiring capitalization and possibly changing an entity's practice compared to prior financial statements.

Why require capitalization now ?

While I recognize that some will argue that allowing entities the option to capitalize these costs will detract from consistency among entities, existing practice today in a number of far more important items detracts from true consistency among entities. For example, generally accepted accounting principles permit a number of varying cost assignment bases for the purpose of valuing inventories, among them, LIFO, FIFO, weighted-average cost, and specific identification.

Do the benefits of reporting those costs as assets exceed the costs of such reporting ?

I have no basis on which to offer a comment.

Should the SOP specify that amortization should not exceed a maximum period ?

No, the accounting model has and will continue to require preparers to use their professional judgment and make estimates in a number of areas.

Should the SOP require certain methods of amortization ?

No, this asset, if capitalized, is no different than other types of assets where generally accepted accounting principles permit various methods, **subject to their disclosure.** As with other assets subject to periodic amortization, disclosure, while beneficial, will not at the present level of detail enable a user to create a completely accurate comparison among entities using different methods or lives.

Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-lived Assets and for Long-lived assets to Be Disposed Of ?*

Yes.

If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment ?

Yes.

Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use ?

No. If an objective of this SOP is to increase the consistency of application of some principles, then adding this requirement will only give entities great latitude in defining "technological feasibility" which in turn will enable those entities that wish to present a "conservative" statement of financial position and results of operations to expense considerably more than some other entity.

Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets ? Why ? What costs should be included or excluded ?

I believe that reasonable professionals may have widely different views about what should be capitalized. I believe that incremental costs, including some that the proposed SOP might consider general and administrative, should be included as long as the costs of capturing these are not burdensome. It is not clear from the proposed SOP wording whether travel expenses would be capitalizable. In general, if any "allocation" is required, (i.e. rent, or other occupancy costs), then I would exclude these, whereas there are some general and administrative that may be truly incremental, (i.e., telephone or communications costs), that should be included. As in all cases, the overall materiality would also be a factor.

Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use ?

Yes, the guidance is adequate and again some professional judgment will be required and although there may be some abuses.

Do you agree with the approach in this proposed SOP that requires an entity to follow the guidelines in either this proposed SOP or FASB Statement No. 86, but not both ?

Yes.

The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational ?

As in many other areas of accounting, reasonable individuals may reach far different conclusions based upon the guidance provided. Specifically I would like to address the so called "Year 2000" ("Y2K") issue facing users of software. Using the definition in the proposed SOP and FAS 86, I would conclude that Y2K costs should be capitalized because such efforts will unquestionably extend the useful life and functionality of something that may otherwise cease to function after December 31, 1999. To imply that Y2K costs are "routine" maintenance would, in my view, indicate that the Committee believes that internal use software has a very long life and should be created to address all contingencies. In many instances entities addressing the Y2K issue are doing so by reengineering their systems and a categorical prohibition would appear unreasonable. However, this point of view and interpretation appears to conflict with the pronouncement of the Emerging Issues Task Force 96-14 ("EITF") of the FASB, although I hope that this was a temporary position pending the final issuance of this proposed SOP.

The accounting model already provides for similar treatment, that is capitalization of major costs that extend the life of an asset, so with respect to Y2K efforts, I see no difference.

In addition, the reaffirmation of the EIFT's position that Y2K costs must be expensed may in my view encourage entities to explicitly seek to purchase new software that address this issue, and presumably therefore capitalize such costs rather than possibly seeking to address the matter internally and possibly more efficiently. I believe that it would be unfortunate, but probably not the first time that an accounting pronouncement from some portion of the recognized profession resulted in possible uneconomic activities to achieve some sought after "accounting" answer, i.e. capitalization of costs and deferral of expenses to future periods.

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One area that the SOP does not specifically address is the accounting for upgrades by the acquiring entity. Upgrades may be acquired through either "maintenance" agreements or outright specific acquisition, predominantly in the personal computer market.

Guidance in the proposed SOP should address whether upgrades acquired as part of a "maintenance" agreement should be capitalized, which would require an allocation and deferral of a portion of the "maintenance" costs.

The example and discussion that follow are provided to show that a number of alternatives exist with respect to outright specific upgrade acquisitions and, if an objective of this proposed SOP is consistency, then some guidance would be helpful.

Assumed Facts: An entity acquires internal use software on January 1, X1 for $ 500 and assigns an estimated useful life of 5 years. On January 1, X3, the entity acquires version 2 of this same software for $ 100, with an expected useful life of 5 years. The purchase price of the upgrade is only available if an entity has the prior version. A new version of the latest release is available for $ 550.

What is the recommended accounting in years X3, X4, X5, X 6, and X 7 ?

Option A Write-off the unamortized balance resulting from the initial acquisition and amortize the upgrade over its estimated useful life of 5 years.

Option B Amortize each of the respective pieces over their estimated useful lives.

Option C Combine the two acquisitions and amortize over the remaining life of the original software acquisition.

Option D Combine the two acquisitions and amortize over the expected life of the upgrade.

First, the following is a numerical summary of the different treatments.

	Charged to operations					
	X 3	X 4	X 5	X 6	X 7	Total
Option A	320	20	20	20	20	400
Option B	120	120	120	20	20	400
Option C	133	133	134	-	-	400
Option D	80	80	80	80	80	400

It appears that the results offer a range of potentially materially different answers. The arguments for / against each treatment include the following:

Option A

For The original purchased software is obsolete as evidenced by the upgrade and has no remaining value.
Against The original code is a part of the remaining software package in total and has not lost its remaining value, but has been enhanced by the upgrade.

Option B

For The upgrade while enhancing the original code does not extend the useful life of the original component, but has a unique life of its own.
Against The upgrade does not function on its own.

Option C

For The upgrade and the original code are completely linked and integrated, but the upgrade does not extend the original component's useful life.
Against The upgrade and original are separate acquisitions and should be viewed as such.

Option D

For The upgrade and the original code are completely linked and integrated, and extend the useful life of the new combined code.
Against The upgrade and original are separate acquisitions and should be viewed as such.

I believe that Option D is the preferable alternative and some statement or example to that effect somewhere in the final SOP or an appendix thereto would be beneficial.

If you or any member of the Committee desires any amplification or clarification of any portion of the contents, I would be pleased to respond. I would like to thank you again for this opportunity to have my thoughts, views and questions considered by the Committee.

Very truly yours,

New England Investment Companies, L.P.

G. Neal Ryland
Executive Vice President
and Chief Financial Officer

April 9, 1997

Mr. Daniel Noll
Technical Manager
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1211 Avenue of the Americas
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Dear Mr. Noll:

I am writing to express my concern and that of New England Investment Companies, L.P. related to the Exposure Draft of a Proposed Statement of Position prepared by the Accounting Standards Executive Committee (AcSec) of the American Institute of Certified Public Accountants (AICPA) entitled "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" dated December 17, 1996.

New England Investment Companies, L.P. strongly opposes the accounting treatment set forth in the Exposure Draft. The proposed accounting, which mandates the capitalization of internally developed software costs, introduces an element of subjectivity that is not present under current accounting practices whereby costs associated with internally developed software are expensed.

Under the proposed accounting rules, management judgment becomes the key determinant in assessing when capitalization should commence or halt, the length of the asset's useful life and if asset impairment has occurred. The interpretation of these questions will create an environment in which capitalization policies may vary considerably from entity to entity, thus distorting current earnings, creating soft assets on the balance sheet and overstating an entity's net worth.

Besides introducing more subjectivity to current accounting practices, there are other significant issues created by this Exposure Draft.

- The matching concept requires that expense recognition occur when the actual benefits or revenues are realized. Capitalization of internally developed software will cause inconsistencies in matching revenues with expenses. Internal use systems do not always clearly demonstrate a direct, measurable benefit. Certain benefits, like enhanced customer satisfaction or an improved workplace environment, are intangible and difficult to measure. Valuing and matching these types of benefits with the related expenses will be difficult and subject to interpretation.

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- The ability to efficiently develop software varies from company to company, application by application. There is no assurance that products developed for similar end-use with similar functionality will have comparable capitalized values. Accordingly, companies which develop the same product but at significant cost differentials will have the same asset recorded but at different values.

- The accounting requirements related to tracking project component development costs could be cumbersome and labor intensive. Tracking each project component against the various stages of development and determining when costs associated with each component are capitalizable could be a significant accounting burden. The incremental costs incurred vs. the benefits derived warrant additional consideration.

- The Exposure Draft could result in adverse tax ramifications should the IRS choose to adopt the AICPA's recommendations.

Based on the comments highlighted above, the Exposure Draft failed to achieve its purpose, greater consistency in the accounting for software. As such, the current generally accepted accounting practice which expenses all internally developed software costs is **the only** accounting practice which promotes consistency in accounting from entity to entity.

Sincerely,

G. Neal Ryland

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Medtronic

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April 7, 1997

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Re: Proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Dear Mr. Noll:

In response to the Proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" please consider the following views regarding some of the issues presented in the "Areas Requiring Particular Attention by Respondents" section of the proposed statement.

Issue 1: "Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?" Currently, software costs are making up a more significant portion of total computer systems costs, as compared to hardware costs. This trend is the exact opposite of the cost composition between hardware and software costs of several years ago. In addition we believe current accounting practices for internal use software are diverse as a result of a lack of authoritative guidance related to internal use computer software.

In general and from a theoretical standpoint we agree with the AcSEC's conclusion, as stated in paragraph 56 of the proposed statement, that the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, are related to probable future economic benefits (FASB Concepts Statement No. 6) and meet the recognition criteria of definitions, measurability, relevance, and reliability (FASB Concepts Statement No. 5).

In addition, we believe entities use software for the same purposes as they use other long-lived assets: to reduce costs, to operate more efficiently, to improve internal controls, to service customers better, and to gain competitive advantages. As the business environment continues to move farther away from the industrial age and further into the information age, we believe our computer software is as important, if not more important in some instances, as our other assets currently recorded in property, plant and equipment.

We believe that the ability of a financial statement user to compare financial information between enterprises is a crucial objective of generally accepted accounting principles. Hence, we agree with the AcSEC's conclusion in paragraph 60 that entities should not have the option to expense costs of computer software developed or obtained for internal use, unless the dollar amounts involved are clearly immaterial to the entities financial statements. We agree with the AcSEC's conclusion in paragraph 78 of the proposed SOP that states an entity can best determine the materiality thresholds to determine when an entity should follow the guidance in this SOP. We believe that entities should have the ability to immediately expense the costs of immaterial computer software projects, as considered both individually and in the aggregate, as the administrative costs related to the accounting and tracking for such minor computer software projects are greater than the benefits derived.

We believe that the benefits of reporting the costs of computer software developed or obtained for internal use clearly exceed the costs of such reporting. We anticipate such costs could be tracked and recorded for the most part within our existing construction in progress and fixed asset reporting systems. However, some modifications to existing systems would be required to allow us to more efficiently monitor and capture within the CIP project system internal payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal use software project.

Issue 2: "Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization?" We agree with the AcSEC that a stated maximum amortization period in the SOP is not required. We believe that individual entities are in a better position to estimate the useful life of the software and that entities should consider the effects of such things as obsolescence, technology, competition and other economic factors. We would generally expect this useful life amortization period to be the shorter of the useful life or five years and would generally use the straight line method of amortization. While we agree with paragraph 32 of the proposed SOP that amortization should begin when the computer software is ready for its intended use, we would anticipate that for a worldwide computer software project, such as a roll out of a general ledger system on a worldwide basis, would be amortized beginning in stages, over the useful life of the software, as the computer software is ready for its intended use in each individual country.

Issue 3: "Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?" We believe that SFAS No. 121 provides sufficient guidance with regards to recognizing impairment of previously capitalized internal-use computer software costs. Paragraph 7 of SFAS No. 121 states that "an impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale." We believe the use of available market values, or market values for similar assets would be most helpful in estimating the fair value of an asset in question. As an alternative, we do not believe it would be appropriate nor feasible to attempt to estimate fair value by calculating the present value of future cash flows related to the software based on a discount rate commensurate with the risks involved. After an impairment write-down is recognized, we agree that the reduced carrying amount of the asset should be accounted for as its new cost over the remaining useful life of the asset in accordance with paragraph 10 of SFAS No. 121.

Issue 4: "Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?" We agree with the AcSEC's conclusion in paragraph 45 of the exposure draft SOP that the technological feasibility criteria in FASB Statement No. 86 "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed" relates to software that will be sold, leased or otherwise marketed as a separate product or as a part of a product or process. We believe that the technological feasibility criteria should not be required if no plans exist to market the software externally, and that internal use computer software should be capitalized based on accounting principles similar to those for property, plant and equipment and other long-lived assets. We believe that should it be concluded at any time during the software project that it is no longer probable that the software being developed will be completed and placed in service, any previously capitalized costs should be recorded at the lower of carrying amount or fair value, if any, less costs to sell, in accordance with SFAS No. 121.

Issue 5: "Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?" Overall, we believe that the proposed SOP does a good job of defining the types of costs that can be capitalized and those that should be expensed. One exception relates to capitalized interest. Due to the cost/benefits relationship and the anticipated immaterial amount of interest cost incurred while developing most internal-use computer software, we do not agree that it is beneficial to capitalize interest in the costs of computer software developed or obtained for internal use. We agree that excluded items should include such things as G&A costs, overhead burden costs, minor upgrades and enhancements, software maintenance and support fees, training costs, user manuals and other technical software instructional aids, costs of software used in R&D activities and external and internal costs specifically associated with modifying internal use software for the year 2000. In addition, we believe that personal desktop software such as Windows 95, Excel, Office 97, etc. should not be capitalized even if it meets the capitalizable costs criteria of paragraph 26 of the proposed SOP since such software usually has a very short useful life. We also noted that the proposed SOP does not address perpetual software licenses. Such agreements allow a company to buy the right to use the software while the vendor maintains ownership of the software. We believe that such costs should be capitalized as well, and amortized over the length of the license agreement.

Issue 6: "Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use?" We believe that paragraph 11 of the proposed SOP and the Appendix A examples clearly help define the characteristics of internal use software. 1) The software is acquired, internally developed, or modified solely to meet the entity's internal needs and 2) during the software's development or modification, no plan exists to market the software externally. We agree with paragraph 33 of the proposed SOP that states any proceeds received from the sale of computer software originally developed or obtained for internal use should be applied against the carrying amount of that software and that no profit should be recognized until aggregate proceeds from sales exceed the carrying amount of the software.

Issue 7: "Do you agree with the approach in the proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both?" We agree that entities may develop computer software for internal use and may also plan to sell, lease, or otherwise market the same software to recover some costs. However, we agree with the AcSEC's conclusion in paragraph 38 that it would be difficult and most likely impractical to allocate such costs between internal use software and software to be marketed. Hence, we believe that if the software is developed by that entity and is intended for eventual sale, lease, or other marketing, it should be subject to the guidance of SFAS No. 86. However, we do feel that an entity should be allowed to follow the added guidance in this proposed SOP as well. Particularly the additional guidance provided in paragraphs 41 and 42 that may help entities determine whether the specified computer software is for internal use and subject to the SOP or "part of a product or process" and subject the to accounting requirements of SFAS No. 86.

Issue 8: "The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?" We agree with the AcSEC's conclusion in paragraph 63 that the costs of significant upgrades and enhancements to internal-use software should be capitalized if it is probable that those expenditures will result in significant additional functionality. We believe this significant additional functionality would be supported by an expected extension of the useful life and an improved efficiency to the original product.

Other Issues:

Paragraph 36 of the proposed SOP states that "costs incurred prior to the initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred". We want to acknowledge our agreement with this requirement as we believe the costs required to accumulate the necessary level of detailed information for such a restatement process are significantly greater than the perceived benefits of such disclosures to the readers of the financial statements. However, we do agree with the AcSEC that costs capitalized before the application of this SOP should be subject to the impairment and amortization provisions of this SOP.

In summary, we agree with the majority of guidance and conclusions reached by the AcSEC as described in the proposed SOP and we appreciate your efforts to provide additional authoritative guidance related to internal use computer software. We appreciate your consideration of our views and comments on this very important subject and welcome any questions or comments you may have.

Sincerely,

Gary L. Ellis
Vice President
and Corporate Controller

Robert L. Ryan
Senior Vice President
and Chief Financial Officer

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Stanford University

OFFICE OF THE CONTROLLER

April 11, 1996

Daniel Noll, Technical Manager
Accounting Standards, File 4262
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1211 Avenue of the Americas
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Dear Mr. Noll:

In response to our review of the exposure draft for the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. we noted two areas of concern.

Our first concern pertains to the preliminary project stage. As the current exposure draft reads, conceptual formulation, design, and testing of possible internal-use computer software project alternatives are excluded from costs being capitalized as a long-lived asset. These costs are considered research and development. The preliminary project stage of internal-use software is an essential stage in selecting and developing an appropiate software prototype for an entity's needs. By excluding these costs from the amounts qualifying for capitalization, entities may not be encouraged to find the best possible prototype for their needs. This may result in further delays and additional costs to the project at later stages in the computer software development, which may have been avoided if more time were spent in the preliminary project stage.

One possible alternative in keeping a reasonable amount of the "research and development" costs in the preliminary project stage is to have management monitor the accumulation of project development costs. If these costs plus the expected costs to be incurred in other stages of development significantly exceed the amount originally expected to develop the internal-use software, then the recoverablity of the carrying amount of the asset should be assessed in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* Professional judgement should be used to evaluate reasonableness. Estimates should consider the current market costs to purchase and install software.

The second concern relates to training costs. Under the current exposure draft, training costs should not be capitalized as costs of internal-use software. Training an entity's personnel as to how to use the intended internal-use software is a critical step in the success of the software. The Accounting Standards Executive Committee (AcSEC) states that training is thought to have an indeterminate life. However, the initial training appears to correspond with the life of the asset as the information on use of the software is disseminated during the life of the asset. Proper training is an integral part of a new system. Viewed in this context, training is to system implementation as preparation of land would be toward its intended use. The latter is capitalized thus the former should be also.

When deciding which costs to include and exclude for capitalization of internal-use software it seems appropriate to include types of costs that are included in the purchase price of software from an external vendor, a long-lived asset. It is typical that both the conceptual formulation, design and testing, and the initial training costs are included in the purchase price. In order to compare the cost of purchasing new software versus the development of internal-use software it is necessary to maintain similar treatment of costs included in the price of the software. Thus it appears reasonable that these cost should be included in the amounts to be capitalized for internal-use software.

Sincerely,

M. Suzanne Calandra

M. Suzanne Calandra
Controller

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KATHRYN M. WELLING
ASSOCIATE EDITOR

April 3, 1997

Mr. Don Noll
Technical Manager
AICPA
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Dear Mr. Noll:

As a constant user of financial reports and frequent interpreter of same for our investment-oriented readership, I applaud the FASB's proposed standardization of corporate reporting of software development costs.

But, please, make sure you do a complete job by also mandating adequate disclosures to inform investors that the accounting change is responsible for changes in reported earnings -- including the dollar amount of any such earnings enhancement or decline.

Regards,

KMW:la

MEADOWBROOK
INSURANCE GROUP

April 2, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards , File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Mr. Noll,

Meadowbrook Insurance Group, Inc. (the Company) generally supports the Accounting Standards Executive Committee's (AcSEC) Exposure Draft of the Proposed SOP *"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"*, however we would like to comment on the following issues: " Should the costs of computer software developed or obtained for internal use be recognized as assets?" " Should entities have the option to capitalize or expense such costs?" "Do the benefits of reporting theses costs as assets exceed the costs of such reporting?" "What are the costs of reporting?" These items are outlined in *paragraphs 50-67* of the exposure draft.

The Company agrees that costs of computer software developed or obtained for internal use should be allowed to be capitalized, however we do not agree that this should be a requirement, as outlined in *paragraph 60*: By requiring companies to identify such costs and capitalize them, it takes away an entity's choice to be conservative and expense these costs as incurred. In many cases, the use of internal resources for identifying and reporting such costs for capitalization could outweigh the benefits of the additional value of information. For example, the effort involved in the accurate tracking of time spent by employees involved in software development and the allocation of these employees salaries and benefits may not be justified by material dollars. In addition, once these costs have been capitalized, entities must constantly monitor these assets for impairment. In conclusion, we believe it should be management's' individual choice whether to go through the time and expense involved in capitalizing these costs and monitoring for impairment or just to expense these costs as incurred.

Sincerely,

Suzanne R. Vahratian

Suzanne R. Vahratian, CPA
Senior Financial Analyst

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John P. Meyer
Senior Vice President & Controller

April 11, 1997

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RE: Exposure Draft of a Proposed Statement of Position - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

Sprint Corporation (Sprint) is pleased to have the opportunity to comment on the Exposure Draft of the Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (SOP). Sprint is a global communications company at the forefront in integrating long distance, local and wireless communications services, and is the leader in advanced data communications services. Sprint has $14 billion in annual revenues, $17 billion in assets and serves more than 16 million business and residential customers.

We concur with the Accounting Standards Executive Committee (AcSEC) conclusion that costs of computer software developed or obtained for internal use should be recognized as assets. Software is swiftly becoming one of the most critical, and financially significant assets for many industries as they become less reliant on traditional hardware assets. Particularly in the telecommunications industry, there is an increasing reliance on software to provide additional feature-enriched services (e.g. voice mail, call forwarding, and caller ID) beyond the traditional capabilities of a network switch. Additionally, software can be utilized to enhance the performance of the network by providing enriched call routing capabilities or enable the aggregation of voice and data communications.

We do not, however, agree with AcSEC's opinion that "general and administrative costs, overhead costs, and training costs should not be capitalized as costs of internal-use software; those costs relate to the period in which they are incurred." It is our opinion that general and administrative costs, overhead costs and training costs (collectively referred to as "overhead costs") attributable to the software development process should be capitalized as an integral component of the cost of software development.

The AcSEC recognized that the costs of some activities, such as allocated overhead, may be part of the overall cost of assets, but excluded such costs because measurement of the amounts to be allocated to the total cost of the computer software are too imprecise. This exclusion of overhead costs is not consistent with the well-established practice of capitalizing such overhead costs for self-constructed assets. All of the costs incurred of putting a self-constructed asset into the condition and location for use are capitalized. It is our belief that the characteristics of overhead costs incurred in software development are not unique or different from those of other self-constructed assets. There is certainly room for interpretation as to what constitutes attributable overhead costs, however, we believe that the determination of such costs are reasonably determinable and should be included as a component of the cost of self-constructed software.

Additionally, we believe that it would be inappropriate for the accounting treatment to create a difference between the cost of self-constructed software compared with purchased software because of the exclusion of similar economic costs. Purchased software would clearly include an allocation of overhead costs, while the proposed SOP would preclude the inclusion of such costs for self-constructed software. The purpose of accounting is to reflect the true economic difference between the purchase of software and the development of software internally.

Furthermore, there is existing guidance within Generally Accepted Accounting Principles which would seem to support the inclusion of overhead costs as a component of the cost of self-constructed software. Statement of Financial Accounting Standards (SFAS) No. 34, "Capitalization of Interest Cost" is consistent in that "the historical cost of acquiring includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use." SFAS No. 34 also states "the objectives of capitalizing interest are (a) to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset and (b) to charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited." These concepts are consistent with capitalizing overhead costs to reflect the total investment in the software and to charge that cost to the future periods benefited.

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed" also supports the inclusion of all costs of production of software incurred subsequent to establishing technological feasibility should be capitalized. SFAS No. 86 also recognized that the costs of internally developed software should be accounted for consistently with purchased software for external reporting purposes.

In summary, we concur with AcSEC's belief "that entities develop or obtain internal-use software often for the same end-purposes that they develop or obtain other long-lived assets (e.g. to reduce costs, operate more efficiently, improve internal controls, service customers better, and gain competitive advantages)." It is our belief, however, that the costs of such computer software assets should be accounted for consistently with the costs of other long-lived assets and therefore should include the overhead costs attributable the to software development process. Accordingly, we urge the AcSEC to reconsider its position on this issue.

Again, we appreciate the opportunity to offer our comments. Please call Doug Lynn at (816) 854-5340 if you wish to discuss the comments and observations in this letter.

Sincerely

John P. Meyer

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RANCHO PALOS VERDES
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April 12, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262: Proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Dear Mr. Noll:

I am a CPA and was a long-time member of the Accounting Standards Division's Task Force on the Development and Sale of Computer Software, as well as a member of the Accounting Standards Executive Committee. I am currently Chief Financial Officer of ICU Medical, Inc., a medical device manufacturer that has a very substantial investment in software used for management, product design and production applications.

I support the basic conclusions of the proposed SOP. As explained below, there are a number of significant improvements that should be made in the proposed SOP to make it more understandable and provide guidance in areas where it is incomplete or ambiguous.

I will comment first on the areas requiring particular attention by respondents.

(1) Costs of computer software developed or obtained for internal use should be recognized as assets, and there should be no option as to such capitalization, for the reasons in the proposed SOP.

(2) Amortization periods and methods should not be specified, nor should any guidance on selecting such periods and methods be provided. The issues are not significantly different than those related to depreciation or amortization of other assets.

(3) SFAS No. 121 is currently applicable to internal-use computer software assets, and no further guidance should be provided. While SFAS No. 121 is difficult to apply to many internal-use assets, particularly those used in administrative functions that do not typically generate their own cash flows, the issues related to internal-use software are not sufficiently different from those related to other types of assets to warrant separate guidance.

(4) The conclusion in the proposed SOP to not require that the technological feasibility criteria of SFAS No. 86 be met is correct and appropriate.

(5) The proposed SOP is too "narrow" in specifying the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. Cost accounting practices generally used for other self-constructed assets should be followed, thereby capturing not only payroll related fringe benefits but other indirect costs such as costs of occupancy and assets used in creating software such as computer depreciation and amortization of software tools. Those costs can usually be determined with the same level of precision as overhead capitalized as costs of other self-constructed assets and inventory, and would be included in the costs of those assets. The reference to SOP 93-7 and SFAS No. 91 as a basis for excluding allocated overhead is inappropriate; determination of the scope and amounts of overhead allocable to costs capitalized under those statements is complex, and such complexity would rarely exist in determining overhead allocable to costs of internal-use software. The statement in paragraph 68 of the proposed SOP measurements of allocable amounts are too imprecise has little, if any, basis in fact.

(6) The guidance in the proposed SOP to help entities determine whether computer software is for internal use is excellent. It is theoretically sound and quite practical.

(7) I do not agree with the proposed SOP's conclusion to, in effect, use SFAS No. 86 as the sole guidance for software obtained or developed for both internal use and external marketing. I do agree that an entity should follow the guidance in either the proposed SOP of SFAS No. 86, but not both. The principal purpose of purchasing and developing software is usually apparent, and is often obvious based on the entity's principal business activity. The applicable standard should be based on that principal purpose. This would avoid the situation where minor planned incidental marketing of software being developed for internal use would cause, or enable, an entity to not capitalize costs under the proposed SOP.

(8) The guidance to distinguish upgrades and enhancements from "maintenance" is not operational. Entities often receive both product improvements and routine changes and additions under a single "maintenance" contract. That contract often includes support services ranging from a telephone hot-line to on-site help. The contract usually has a single periodic (usually annual) fee that is not allocated to specific items to be furnished. Allocation of cost among elements of the contract is generally not practical because the level of product or service can vary from year-to-year and among different customers, and there is often not adequate information on how those products and services would be priced if sold separately. Further, the

distinction between upgrades and enhancements vs. routine changes and additions is frequently not easily drawn; they are both improvements to the software.

For software that is not developed internally, the proposed SOP should not impose an obligation to attempt to unbundle elements normally purchased under a "maintenance" contract. As a practical alternative, all such costs should be expensed as "maintenance," and allocation of such costs to upgrades and enhancements should be prohibited. This is generally consistent with current practice.

For software that is developed internally, the guidance in paragraphs 63 and 64 is sufficient. Although it is somewhat broad and there may be inconsistencies in how it is applied among entities, it would be futile to attempt to prescribe accounting for all the variations that might occur in practice.

My other comments follow.

<u>Use of the term "maintenance"</u> : The Accounting Standards Division discarded the use of the term "maintenance" in SOP 91-1 for the reasons stated therein. I suggest that the term similarly not be used in the proposed SOP for both clarity and consistency. "Postcontract customer support," the term used in SOP 91-1 should be used to describe purchased "maintenance" and some other term, such as "upkeep" should be used for internal activities related to error correction and routine updates. This would affect paragraphs 25, 27, 64 and 69, 70 and 71.

<u>Definition of upgrades and enhancements</u>: The last sentence of paragraph 24, in describing additional functionality, should add changes to increase the efficiency with which the software performs a task.

<u>Computer Software with training and maintenance fees built into purchase price</u>: Consistent with my comment on issue 8 above, the amount to be unbundled from the software purchase price, as described in paragraph 27, should be the amount the vendor would charge for a "maintenance" contract.

Has consideration been given to how to unbundle the "maintenance" if there is no objective evidence to use to measure the amount of "maintenance"? This is a significant issue in software revenue recognition. I suggest that the proposed SOP carry a requirement that the unbundling be based on all evidence available, and that a paucity of evidence not be a basis for not unbundling.

<u>Internal-use computer software subsequently sold</u>: There is little, if any, theoretical support for the accounting prescribed in paragraph 33 that profit be recognized on the cost recovery method. Further, the paragraph, as worded, is unclear.

Does the paragraph apply only to software "sold," as the paragraph is written, or also to software licensed? If the software is sold, the seller gives up all rights to the software (unless there is a license back to the seller) and there would be no proceeds beyond those in the specific sale transaction, and all costs would be charged against the proceeds, with gain or loss recognized at the time of sale.

If the software is licensed, the licensor grants the licensee a right to use, but not own, the software. This transaction is analogous to the rental of any other asset, such as a building, and the accounting is to charge an appropriate portion of the rented asset's cost against the rental proceeds. This would be the case even if the building was initially built for occupancy by the owner, and would also be the case even if only part of the building is rented. Other analogies can be found in accounting in the motion picture and the record and music industries. The cost recovery method is usually reserved for those transactions where the realization of the proceeds or recovery of costs is uncertain. If it the intention of the proposed SOP to require the cost recovery method for licenses, the proposal should be amended to provide for the conventional accounting used in the license or rental of other assets. If AcSEC is concerned with allocation of costs to the license transaction, this is not a valid reason to upset the entire revenue recognition model; the allocable costs, in fact, may be small so failure to recognize the proceeds as income would fail to fairly represent the transaction in the financial statements.

* * * * *

I would be pleased to discuss my comments, or other aspects of the proposed SOP, with AcSEC or the Task Force.

Very truly yours,

Francis J. O'Brien

LONG ISLAND BANCORP INC

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MARK FUSTER
EXECUTIVE VICE PRESIDENT AND
CHIEF FINANCIAL OFFICER

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Proposed Statement of Position - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.

Dear Mr. Noll,

Long Island Bancorp, Inc. would like to thank you for the opportunity to comment on the aforementioned statement proposed by the American Institute of Certified Public Accountants.

Currently, there is no clear authoritative guidance to ensure consistent accounting treatment for recording the costs of software developed for internal use. The proposed statement addresses this deficiency by first defining internal use software as:

- Software that is acquired, internally developed or modified solely to meet the company's internal needs, and
- Software that is <u>not</u> developed or modified under a plan to market the product externally.

If software meets both of the above criteria, the costs incurred are subject to the provisions of the proposed statement. If it does not, the related costs are accounted for under Statement of Financial Accounting No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed". The proposed statement establishes clear guidelines for expensing and capitalizing the costs associated with internal use software. Costs that would be expensed are those incurred in connection with research and development and in the preliminary project stage of the software development. Once the company has passed the research and development stage, costs incurred such as external direct costs, payroll and appropriate interest calculated under Statement of Financial Accounting Standard No. 34, "Capitalization of Interest Cost," should be capitalized. Ongoing costs associated with the software would be capitalized if they result in enhancements to the software or expensed as maintenance. We believe these guidelines for capitalizing and expensing costs are necessary and adequate to provide comparability and consistency between business entities. Further, the requirement to capitalize and amortize certain costs of internal use software use over the expected period of benefit is in accordance with the basic accounting concept of matching.

The proposed statement also provides for the recognition of impairment of internal use software in accordance with Financial Accounting Standards Board Statement No. 121("SFAS 121"), "Accounting for the Impairment of Long-Lived Assets and Assets to be Disposed Of". We believe that it is appropriate to apply SFAS 121 to software since software is subject to impairment due to the effects of obsolescence, technology and competition.

Once again, we would like to thank you for the opportunity to present our views on the proposed statement and hope that our comments will be considered by the AICPA in its final decision on this proposal.

Sincerely,

Mark Fuster
Executive Vice President and CFO

cc: J. Conefry
L. Peters
R. DiPaola
S. McGannon

April 15, 1997

INSO Corporation — NASDAQ

Daniel Noll
Technical Manager Accounting Standards, File 4262
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Statement of Position,
"Accounting for the Costs of Computer Software Developed or
Obtained for Internal Use"

Dear Mr. Noll:

I am pleased to provide our comments on the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants' (AICPA) proposed Statement of Position (SOP): *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Under the Exposure Draft, standards would be established which would require companies to capitalize certain costs to develop or obtain internal-use software. Given the increase in the amount of funds spent on developing and obtaining internal-use software over the last several years, the lack of authoritative guidance and the diversity in accounting amongst entities, we concur with AcSEC's proposed Statement of Position.

Capitalize or Expense

As stated above, the proposed statement requires that companies capitalize costs to develop or obtain internal-use software. Some debate has occurred on whether the proposal should allow companies to continue following a conservative method of expensing these costs as incurred rather than capitalizing. Given that AcSEC's proposal was intended to help eliminate diversity in accounting for these costs and to improve financial reporting, we believe AcSEC's requirement for companies to capitalize is appropriate. Furthermore, the treatment as an asset acknowledges the future benefit to be derived from the software that has been developed for internal use.

In addition to the above, entities would now be required to track payroll and payroll related costs for employees who are directly associated with and who devote time to internal-use software. We do not believe companies will experience significant cost increases to report these items as assets. Ordinarily, companies with the ability to develop software for internal use, have a mechanism in place to track similar costs for purposes of complying with Statement of Financial Accounting Standards No. 86.

Impairment

The exposure draft recommends that capitalized costs of internal-use software be treated as long-lived assets. As such, impairment would be recognized and measured in accordance with Statement of Financial Accounting Standards No. 121. The proposed SOP does not contain guidance on how to apply the provisions of Statement 121 to software that is in use. Since there are no cash flows directly associated with internal use software, it is likely that impairment would be recognized when management makes a decision to replace the software earlier than anticipated.

Summary

In summary, we concur with the AICPA's recommendation of requiring companies to capitalize the costs to develop or obtain internal-use software. We believe the proposal provides a better framework for companies to follow regarding capitalization as well as increasing consistency in reported assets among entities.

We appreciate the opportunity to present our views and would be pleased to discuss any aspect of our comments further.

Sincerely yours,

Betty J. Savage
Chief Financial Officer

Primadonna
CASINO RESORTS

April 11, 1997

American Institute of Certified
Public Accountants
Daniel Noll, Technical Manager
Accounting Standards, file 4262
1211 Avenue of the Americas
New York, NY 10036-8775

Accounting Standards Executive Committee,

Thank you for allowing me to express my views on the exposure draft entitled "Accounting for the costs of computer software developed or obtained for internal use". The age of the computer has caused a dramatic change in how business operates, and the tools used.
I shall correspond my comments to the issues specifically addressed by the exposure draft. All comments and viewpoints expressed are those of the writer, and are not to be construed to be those of the company.

Issue 1.

The costs of internally developed software costs should not be capitalized unless such software is intended to sold as per FASB No. 86. Software developed for internal use is the creation of an intangible asset whose future value is nebulous in nature. While it may be possible to capture the costs associated with software development through such areas as time records, the future benefit may not be quantifiable or measurable(see paragraph 54). To be able to capitalize the software, the issue of value is paramount. Were the entity be sold, I would not see a buyer paying for this as part of their purchase price as a separate asset. Is a spreadsheet that is a vital management report an internally generated piece of software? It may have greater value that writing code on the system mainframe.

I am concerned in the creation of an asset whose future benefit and value is so uncertain, being capitalized. Determining when that "asset" is impaired, whether enhancements add to the life, as so esoteric in nature that calling such an asset is doubtful to me. Expensing when incurred is and should remain the proper accounting treatment.

The definition of software development is further confused as to what is development. For instance, a purchase of vendor software has a report generation capability. Instead, I rewrite the reports to provide better management information that will assist in decisions to improve revenues and reduce costs. Is this software development? Would my time be capitalized? To me, this is not development, and my time is expensed. But, would the situation be reversed if a programmer was hired to "set up" the reports?

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Again, I would say no, but based upon the discussion in the exposure draft, this may qualify for capitalization, a situation I disagree with.

Let us look at this from the standpoint of taxation. If I am creating an asset for book purposes, would not the taxing authorities require the same treatment for income and property taxes? Once this door is opened, the issue becomes marketing, time spent on strategic planning and budgeting (which are for future periods), and so on. I am reminded of the specter of the Indopco decision. Yes, accounting and taxes are different, but we need to consider how this intangible will grow and be extended, and the true economic impact.

I am concerned with how to determine what is a future benefit, its life, and more importantly, how to treat other intangible costs. I market our product to create a brand name awareness. This will have future value to me by increasing future net cash inflows. Why would this not be capitalized? How do you distinguish a marketing plan from software development for treatment?

Further consideration should be directed as to how to audit the validity of the amounts capitalized, the amortization period, and its impairment? This area could, and given our litigious society, probably be a fee income generation for attorneys. I suspect that the SEC would probably not agree with capitalization, especially since their stance has been towards expensing intangible assets.

Issue 2.

Were such an asset be created, the amortization period should be based upon the expected benefit to be derived, except that the life should not exceed that of purchased software, or the hardware if such hardware is unique and whose software is not transferable. Further, I would establish a maximum life of 3 years because of business dynamics and the constant changes entities undergo. This life limitation is predicated upon the frequency that business managers make changes, especially when there is a change in personnel.

Issue 3.

How can an asset be evaluated for impairment under FASB No. 121 when there is not definable cash flow? The issue is whether the software developed is still being used, and management is relying on the software for decision making. Once again, because we can not measure its future value, we are unable to measure its future loss in value.

Issue 4.

Assuming that capitalization of internally generated software is permitted, the minimum thresholds required by FASB NO. 86 are acceptable criteria.

Issue 5.

Interest costs should not be capitalized in producing an intangible asset. The intent of interest capitalization is for projects and constructions taking extended periods to be produced. I do not believe that an intangible asset meets such criteria.

Issue 6.

The guidance presented in the exposure draft does not define the criteria well. It appears to say that software not planned for sale to others is internally generated software. This is true, but does not narrow the definition well. Refer to the discussion in Issue 1 for discussion of this matter.

Issue 7.

If software is developed for outside sales, then application of FASB No. 86 should be followed. There is no reason to separate the cost between internal use versus external use, and I would conjecture that the allocation would result in an immaterial allocation to internal use.

Issue 8.

Even with purchased software and vendor maintenance and upgrades, the costs are typically expensed over the license period, even when enhancements are provided. The capitalization of enhancements should necessitate that a portion of the original software be abandoned, with a subsequent asset writedown occurring. Realistically, I do not think that such a determination can be made, and as such enhancements should be expensed as incurred.

Thank you once again for allowing me to express my viewpoints on this exposure draft.

Respectively submitted,

Louis W. Sanford

Louis. W. Sanford, CPA
Corporate Controller

PEPSICO INC
PURCHASE, N.Y. 10577
TEL. (914) 253-3406

ROBERT L. CARLETON
SENIOR VICE PRESIDENT
AND CONTROLLER

April 14, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

My staff and I have reviewed the AICPA AcSEC proposed Statement of Position (Exposure Draft), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." We support AcSEC's efforts to develop guidance to help reduce the inconsistencies that currently exist in accounting for internal use software. Below are some suggestions that we believe will improve and clarify the guidance in the final Statement of Position.

Impairment Evaluation for Capitalized Internal Use Software Held For Use

Paragraph 28 of the Exposure Draft makes a general statement that impairment should be recognized and measured in accordance with FASB Statement No. 121 (SFAS 121), *Accounting for the Impairment of Long-Lived Assets and for Long-Lived to Be Disposed Of.* The guidance in the Exposure Draft regarding impairment evaluation under SFAS 121 is solely focused on internal use software that is not completed and placed in service or that is not expected to provide any substantive service potential to the entity. If those assets are not expected to provide any service potential to the entity, paragraph 74 of Exposure Draft requires those assets to be written down to the lower of carrying amount or fair value, less cost to sell, which is generally presumed to be zero.

The Exposure Draft does not clearly indicate how to apply the guidance in SFAS 121 to evaluate impairment for capitalized internal use software held for continued use which is expected to provide substantive future service in the following situations:

- Internal use software held for use by an entity for which development and installation costs have significantly exceeded original estimates or software that is providing some level of substantive service to the entity but may be performing at a sub-optimal level (expensive and sub-optimal performing internal use software).

- Internal use software that is shared by multiple units of an entity that are individually identified as asset groupings at the lowest level of cash flows for purposes of impairment evaluation under SFAS 121 (shared internal use software).

Expensive and Sub-optimal Performing Internal Use Software

Paragraph 28 of the Exposure Draft gives four indicators of when operational computer software should be evaluated for impairment under SFAS 121. We believe that the last three indicators could apply to an operating software application that has been placed in service and will continue to be used by the entity. In most cases, internal use software assets capitalized under the Exposure Draft will not have identifiable cash flows that are largely independent of other assets. The last sentence of paragraph 10 of SFAS 121 addresses impairment evaluation for assets expected to provide service potential that do not have independent, identifiable cash flows. That guidance requires an entity-level cash flow test to evaluate and measure impairment. We believe the Exposure Draft guidance should clarify the application of impairment evaluation in these situations to indicate whether the guidance in paragraph 10 of SFAS 121 or some other method should be followed.

Shared Internal Use Software

Although not clearly indicated in the Exposure Draft, that guidance in the last sentence of paragraph 10 of SFAS 121 may apply to capitalized internal use software assets with future service potential. However, that guidance would seem to be limited to internal use software carried at the corporate level and utilized throughout the entity ("entity-level" assets). SFAS 121 does not require entity-level assets to be allocated to lower level asset groupings for an impairment evaluation. For entity-level assets, an impairment loss would be recognizable only if the sum of the expected future cash flows of the entity (reduced for the amount of cash flows necessary to recover other long-lived assets) is less than the carrying amount of the enterprise assets.

Unlike most internally developed or purchased tangible assets subject to SFAS 121, the nature of computer software lends itself to simultaneous use by multiple units of an entity. We believe in practice it is more common for internal use software to be used on less than an entity-wide basis by two or more units of the enterprise that are individually identified as assets groupings at the lowest level of cash flows under SFAS 121. For example, a retail chain store division may utilize a common point-of-sale inventory software application that is maintained and recorded at the division headquarters level. The Exposure Draft does not address whether such shared internal use software assets should be allocated to the store level (SFAS 121 asset grouping level) in connection with a SFAS 121 impairment evaluation of other long-lived assets or whether those assets should be separately evaluated for impairment using entity level cash flows in accordance with the guidance in the last sentence of paragraph 10 of SFAS 121. We believe the Exposure Draft should provide specific guidance regarding impairment evaluation for capitalized internal use software assets shared by multiple SFAS 121 asset groupings.

SFAS 121 indicates that goodwill identified with impaired long-lived assets and identifiable intangibles should be eliminated before making any reduction in the carrying amounts of impaired long-lived assets and intangibles. If AcSEC concludes that capitalized internal use software should not be allocated to the SFAS 121 grouping level, we believe the Exposure Draft should clarify the order in which entity-level assets, which may include goodwill not identified with impaired assets, should be written down in connection with an impairment. In other words, we believe the Exposure Draft should indicate whether entity-level goodwill should be eliminated before making any reduction in the carrying amount of other entity-level intangible assets including capitalized internal use software.

Upgrades and Enhancements of Internal Use Software Previously Expensed

The Exposure Draft indicates that costs of upgrades and enhancements to existing internal-use software that extend the life or increase the utility of the software should be capitalized. We believe that the Exposure Draft should clarify whether this requirement applies to all internal-use software including software previously expensed under an entity's previous accounting policy or is limited to internal-use software for which costs have been capitalized after the adoption of the final Statement of Position.

* * * * * * * *

Should you have any questions regarding our comments, please feel free to call me at (914) 253-3406 or Mark Sweeney at (914) 253-2613.

Sincerely,

Robert Carleton

Michael A. Graf
Senior Vice President
and Corporate Controller

NORWEST CORPORATION

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612/667-0697

April 14, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of Americas
New York, NY 10036-8775

Dear Mr. Noll:

Norwest Corporation (Norwest) appreciates the opportunity to comment on the American Institute of Certified Public Accountants' Proposed Statement of Position (SOP), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". Norwest is an $84 billion financial services company providing banking, insurance, investments, mortgage and consumer finance and other financial services through 3,642 stores in all 50 states, Canada, the Caribbean, Central America, and elsewhere internationally.

Norwest disagrees with the proposed SOP's requirement to capitalize software developed or obtained for internal use. Such costs should be recognized as expense when incurred. Although the proposed SOP attempts to promote standardization in accounting for internal use software, we believe capitalization of this software will result in greater inconsistencies in reporting among companies and industries.

The proposed SOP does not address how the efficiency or utility of design and development costs incurred for internally generated software impacts the level of capitalized costs. For example, a company which lacks experience in the design and development of computer software may capitalize its inefficiencies and have a higher level of capitalized costs in support of a product with less utility and real value. Consequently, two companies developing essentially the same product may report significantly different financial results due to the varying levels of capitalized costs.

The useful life initially assigned to both internally generated and purchased internal use software will vary between companies resulting in a lack of comparability across businesses and industries. Also, it will be difficult to re-assess the useful life of various capitalized software products given the significant, yet uneven, technology changes being experienced in all industries. Companies in search of greater efficiencies may more frequently replace software when improved technology is available and, therefore, will be at greater risk to recognize unexpected losses on the replacement of software.

With respect to upgrades, the proposed SOP does not clearly specify when costs should be capitalized or recorded as maintenance. The SOP allows significant judgment in evaluating increased functionality. This may lead to further inconsistencies in accounting among companies and industries.

The proposed SOP will impose a significant burden upon some companies to develop and maintain cost accounting and project monitoring systems to record, analyze, track and control the capitalization and amortization of these development costs. Even companies with such systems will likely have to modify them and related processes to enable compliance. The additional costs to implement and maintain the systems required to support the SOP will likely outweigh any value derived from application of the proposed SOP given the relatively short useful life of software in the current rapidly-changing, technology environment.

We do not believe that following FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, would be a practical way to calculate impairment of internal software. Due to the customized nature of some software it may not be feasible to determine fair value based upon what a willing party would pay. It may also be difficult to determine specifically which cash flows relate to a given software application. Furthermore, the number of periods and discount rates will be different among industries which would lead to significant distortion, and increase inconsistency among reporting entities. Expensing the costs when incurred will eliminate the burden and uncertainty related to subjective periodic adjustments.

A more conservative and practical approach to account for the cost of software developed or obtained for internal use is to expense such costs when incurred. This will minimize the subjectivity in application of the SOP and the related inconsistencies in financial reporting. It would also avoid the additional recordkeeping burden the proposed SOP will impose. We would like to thank you again for the opportunity to comment on this proposed SOP and will be pleased to discuss our comments with you at your convenience.

Very truly yours,

Michael A. Graf

Michael A. Graf
Senior Vice President
and Corporate Controller

BELLSOUTH

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W. P. (Pat) Shannon
Vice President and
Controller

404 249-5798

April 14, 1997

Mr. Daniel Noll
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262

Dear Sirs:

On behalf of BellSouth Corporation ("BellSouth"), I am pleased to have this opportunity to respond to your request for comments relating to your exposure draft of a proposed Statement of Position ("SOP"), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. As information, BellSouth is one of the most widely held stocks in the United States. The shareholder base is comprised of approximately 1.1 million shareholders of record and over 400,000 accounts in street name. As a public company, we are committed to meeting the information needs of our investors.

Upon review of the SOP, it is our view that internal use software costs (except initial operating system software costs), whether purchased or developed internally, should be expensed as incurred. We believe that companies should not be allowed the option to capitalize these internal use software costs. Further, BellSouth has participated in the development of the United States Telephone Association's response to the SOP and we are fully supportive of this industry position.

Industry Practice and Experience

The SOP refers to the definition of assets contained in FASB Concepts Statements No. 6, *Elements of Financial Statements*, and the criteria that should be met to recognize an item in financial statements contained in Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. BellSouth does not argue the technical correctness of the AICPA's Accounting Standards Executive Committee's ("AcSEC") view. However, BellSouth believes AcSEC will find invaluable our industry knowledge about the probable future economic benefits of software developed or obtained for internal use.

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Previously, the Federal Communications Commission ("FCC") addressed the accounting for software when it adopted its new Part 32 accounting rules which for the first time incorporated US GAAP to the extent regulatory considerations would permit. In that proceeding, the FCC initially proposed an accounting model for software identical to the model proposed by this SOP. AT&T's May 3, 1985 response to that proposal offered the following insights regarding the future economic benefits of internal use software:

> "The future economic benefits associated with software are often of a tenuous and highly questionable nature. This is particularly true in the telecommunications industry in which technological advances are proceeding at an explosive pace. Virtually every technological change that occurs requires some revision to or replacement of the software used by carriers. Consequently, it is virtually impossible to predict in advance the period over which software will produce an economic benefit for the entity. Furthermore, software rarely remains static in the manner in which it performs a particular function. New and improved generations of software are constantly being developed and deployed to accomplish the same function more efficiently or quickly, to accomplish enhanced or improved functions or to consolidate different functions that previously were accomplished separately. Whether such improvements or enhancements are forthcoming and whether they will constitute major revisions to existing generations of software or an entirely new and different generation resulting in a decision to completely replace the old software can rarely be ascertained in advance." (emphasis added)

The FCC spent considerable time evaluating and analyzing the business, operational, and economic ramifications of its position on software costs. Recognizing current industry practice and attempting to reduce difficulties associated with segregations of costs and identifying periods of benefit, the FCC required the expensing of all software costs (purchased or developed internally) except for the cost of initial operating system software. Further, in an Order released May 1, 1990, the FCC stated that the change in accounting which required capitalization of only initial operating system software did little to change the telecommunications industry's predominant practice of expensing costs of internal use software.

AcSEC should note that when AT&T submitted its comments to the FCC in 1985, its wholly-owned subsidiary, Western Electric, was a major source of software for the divested telecommunications carriers. Capitalization of internal use software costs, as originally proposed by the FCC, could have increased Western Electric's sales of internal use software. However, AT&T did not argue the capitalization approach for which they would have benefited.

Just as AT&T anticipated in 1985, the pace of technological change has accelerated. BellSouth's previous internal studies, performed for other purposes, indicated that software installed in its switches in 1989 and 1990 had a life span of between eighteen months to possibly three years. Given recent competitive forces in the telecommunications industry and changes in the Federal and state regulatory environments (e.g., Telecom Act of 1996), it is BellSouth's belief that the life span for its software has decreased since these previous studies were performed. However, this is difficult to determine as addressed in AT&T's response above.

As I am sure that you are aware, the Software Publishers Association has recently requested that FASB Statement No. 86 ("SFAS 86"), *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, be reconsidered and require that all development costs be expensed as incurred vs. capitalized. Even though SFAS 86 and this SOP are based on somewhat different cost capitalization models, our experience and that of the Software Publishers Association's constituents is very similar. The development and deployment of new and improved technologies is ever increasing in the United States and international markets. In this case both producers and purchasers of software acknowledge that software is constantly changing, the pace of change is accelerating, and capitalizing software costs results in recording assets for which realization is difficult to assess.

The foregoing comments of the FCC, AT&T, and the Software Publishers Association as well as our own experience and internal studies suggest that, in current actual practice, software has an indeterminate life as we strive to meet competition and continue to provide our customers with the latest telecommunications services which are based on new and improving technologies. Our experience has been that the extent to which future periods are benefited can not be measured accurately because the rate of change continues to accelerate.

Impact on Financial Reporting

If the provisions of the SOP are adopted, BellSouth has concerns as to the comprehension by readers of the financial statements and whether it enhances the information reported in the financial statements. BellSouth has analyzed actual costs of software purchased by our wireline operations for internal use and charged to expense for the years 1993 through 1996. Actual internal development costs were not included in our analysis as these costs are not readily available.

Our analysis, assuming an average estimated life of 3 years, reflected that by 1996 the amortization expense would have approximated the actual expense amount experienced in 1996. Further, assuming that we would have evaluated no need for asset impairment, BellSouth's 1996 balance sheet would have reflected a new asset ("Software Costs") with a net carrying value of approximately $450 million. To put this in perspective, BellSouth's 1996 total operating expenses were approximately $14.3 billion and the carrying value of long-lived assets was approximately $26.3 billion.

We urge AcSEC to consider the following questions during deliberations on the SOP. Does recording and reporting "soft" assets enhance the value of financial statements? Are users of financial statements better informed if software costs are shifted from cash operating expense to amortization expense? Will users understand that the one time lift in reported earnings is a result of an accounting change from expense of these costs to capitalization? Will financial statement users understand that earnings will decline in each year following this change until the level of amortization expense returns to the level of software expense prior to the change?

Given that we believe that the estimated life of our software is relatively short, the impacts will be even more dramatic and recognized sooner rather than later. In addition, we believe that the SOP opens the door for further divergent and manipulative earnings recognition practices.

First, we feel that the point at which capitalization begins under the SOP is still open to significantly varied interpretation. This problem is exacerbated by the complexity of the software development process. A review of the practices followed in the area of software developed for sale, lease or other marketing shows the tremendous potential for diversity in the application of SFAS 86. While the SOP has attempted to reduce the potential for varied practice, it has left issues such as when an application is no longer classified as in the preliminary project stage and whether or not a software project is a pilot project open to the interpretation of financial statement preparers.

Second, we feel that the SOP calls for a practice inconsistent with that required of companies which develop software for sale as a product. We do not believe that the SOP sets forth adequate justification for setting a standard for capitalization which is different than that of SFAS 86 (i.e., technological feasibility). Furthermore, we think that the risks associated with the development of internal use software are essentially equal to those associated with software being developed for sale. Therefore, we can see no compelling reason why the basis for capitalization would differ.

The surest guarantee of practice uniformity for software development costs is to require treatment of such costs as period costs when incurred.

Implementation Cost

Implementing the accounting proposed in the SOP will be particularly costly for many industries. New time and project tracking systems as well as new project cost allocation processes and systems will be required to be developed and administered. All of these new incremental costs incurred for what we believe at best to be a relatively short-lived asset with questionable value to the readers of financial statements.

In addition to modifying accounting systems to capture and capitalize expenditures previously expensed, companies will be required to separate internal development costs for internal use software projects and software costs of purchased software used for internal use purposes in order to appropriately capitalize interest costs incurred while developing internal use computer software.

In our view, all of these costs significantly outweigh the benefits of the change in accounting treatment the SOP would provide. Rather, as discussed above, we feel that the effect of the treatment will be detrimental to the relevance of financial statements.

* * * * * * * *

In summary, it is BellSouth's position that internal use software costs (except initial operating system software costs), whether purchased or developed internally, should be expensed as incurred. Further, to ensure consistency in accounting treatment, our view is that AcSEC or the Financial Accounting Standards Board should issue a specific standard or an interpretation of existing literature stating that companies should not be allowed the option to capitalize these internal use software costs.

We appreciate the opportunity to offer our comments. Please call me at 404-249-5798 or Blair Parrott at 404-249-5042 if you wish to discuss the comments and observations in this letter.

Respectfully submitted,

Pat Shannon

MBNA AMERICA

M. Scot Kaufman
Vice Chairman
Chief Financial Officer

MBNA America Bank, N.A.
Wilmington, Delaware 19884-0864

(302) 453-6333

April 15, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Executive Committee
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

MBNA America Bank, N.A., a national bank and the principal subsidiary of MBNA Corporation, appreciates the opportunity to comment on the Accounting Standards Executive Committee's (the "AcSEC") December 17, 1996 Exposure Draft, Accounting for the Cost of Computer Software Developed or Obtained for Internal Use (the "Proposal") (File Reference 4262). MBNA America Bank, N.A. is a major bank credit card lender and has total assets of approximately $15.6 billion and total managed loans of $38.6 billion as of December 31,1996.

Absence of Authoritative Literature

Because there is an absence of authoritative literature that specifically addresses accounting for the cost of internal use computer software, practice has become extremely diverse. MBNA commends the AcSEC's effort in eliminating this diversity. We believe that the issuance of this proposal, which will standardize the accounting for cost incurred to purchase or develop internal use computer software, will increase comparability among financial statements.

Computer Software is an Asset

MBNA fully supports the provisions of this proposal. We believe that all costs incurred to purchase or develop internal use software should be capitalized because major computer software expenditures create value beyond a single year. These cost should be spread over the period of expected benefit, rather than expensed as incurred.

Due to the lack of authoritative guidance, computer software may be a significant unrecorded asset for many entities. We believe that the recording of internal use computer software as a long-lived asset would be an improvement in the reporting of these entity's financial statements because the cost would be recognized as an asset and amortized over the period that they benefit.

Businesses are becoming more and more technology driven. Because of the focus on technology and the improvements and efficiencies that come with it, we believe that in terms of generating revenue in future periods, computer software is becoming a greater asset than some fixed assets were fifty years ago. Moreover, computer software is used for the same purpose as other long-lived assets, to create efficiencies, generate revenue, reduce cost and enhance customer service and should therefore be capitalized.

Cost/Benefit Analysis

The benefit of recording costs incurred to purchase or develop internal use computer software as assets exceeds the cost of such reporting. Capitalizing these cost allows entities to recognize future economic benefits and match those benefits with the cost incurred over the period of economic benefit. However, developing a mechanism to capture the cost of internally developed software may be new, time-consuming and cumbersome for some entities. These entities will have to set up cost accumulation methods they may not have as well as devote resources to tracking and monitoring capitalized cost. Be that as it may, we believe that once these procedures are in place, the benefit of tracking these cost will far outweigh the cost.

Once again, we commend your efforts at eliminating diversity in the accounting for internal use software and fully support the provisions of the proposal. We encourage the AcSEC to more forward with the proposal and issue it as it appears in draft form in a final statement of position.

We urge you to consider these comments in your draft. If you have any questions on any of these items, please contact either myself or Victor P. Manning, Senior Executive Vice President and Chief Accounting Officer at (302) 453-6707.

Sincerely,

M. Scot Kaufman

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HERCULES

Hercules Incorporated
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April 15, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards - File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

Exposure Draft
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

We would like to respond to exposure draft number 4262 issued on December 17, 1996, of a proposed Statement of Position (SOP) "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

At the outset we would like to mention that we are a publicly-traded company with revenues of approximately $2.1 billion. Hercules (hereafter referred to as the "Company") manufactures chemical specialty products for a variety of markets worldwide. Its businesses include Paper Technology, Resins, Fibers, Food Gums, and Aqualon water-soluble polymers. With shareholder value as its guiding focus, the Company concentrates on value-added, high-performance products where it has a market or technology advantage. Hercules employs approximately 7,100 people and operates 45 manufacturing plants around the world.

Hercules supports the proposed statement which provides guidance in accounting for the costs of computer software developed or obtained for internal use. This position is based upon the belief that such costs should be capitalized since expenditures of the sort are specifically identifiable, have determinate lives, relate to probable future economic benefits (FASB Concepts Statement No. 6), and meet the recognition criteria of measurability, relevance, and reliability (FASB Concepts Statement No. 5). The Company concurs with the Accounting Standards Executive Committee's (hereafter referred to as the "Committee") conclusions that the costs of computer software developed or obtained for internal use should be amortized in a systematic and rational manner over the estimated useful life of the software. The Company furthermore agrees with the Committee that a maximum amortization period should not be specified since each entity is in a better position to determine an appropriate useful life.

The Company takes no exception to the fact that the Exposure Draft does not require technological feasibility be established prior to capitalization of costs. We concur with the Committee's rationale for this decision since internal-use software is typically not cutting edge in terms of technology and that once a company moves beyond conceptual formulation, there exists little doubt that the software will function technically.

We disagree, however, with the Committee's universal decision to require the expense of all training costs incurred in connection with the installation of related software modules. The Company believes that the future benefits associated with these training costs are inextricably linked to the usefulness of computer software. If an organization intends to realize the benefits expected from the installation of such modules, training expenses invariably will be incurred by the organization. It is our belief that such costs should be capitalized and amortized in a manner consistent with the software to which they pertain.

The Company feels the Committee should mandate the classification of computer software as a tangible (fixed) asset. Such a requirement would provide consistency among reporting entities and support the belief that their capitalization embodies a tangible benefit with a determinate life.

Finally, Hercules feels that the following additional topics should be addressed by the Committee with regard to this Exposure Draft:

a) **Capitalization of data conversion costs.** It is our opinion that costs incurred with regard to the conversion of data for use in new internal use computer software should be capitalized. This opinion is based upon our belief that such costs are comparable to the capitalization of setup costs incurred in preparing an asset for its intended use.

b) **Costs associated with reengineering activities.** Costs associated with reengineering activities (such as interface construction and process flow analysis) connected with the implementation of internal use computer software should be capitalized. Similar to data conversion costs above, such expenditures are necessary to ensure that the new software functions as planned.

Very truly yours,

G MacKenzie

George MacKenzie
Senior Vice President and
Chief Financial Officer

cc: Vikram Jog

GM/edg
XposDrft.pmp

Ætna

151 Farmington Avenue
Hartford, CT 06156

Robert J. Price
Vice President and
Corporate Controller
860/273-1590

April 17, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036 - 8775

RE: Exposure Draft, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
File 4262

Dear Mr. Noll:

We appreciate the opportunity to provide you with our comments on the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. We believe that capitalizing amounts expended for internal-use computer software costs is consistent with the essential characteristics of an asset as defined in FASB Concepts No. 6, *Elements of Financial Statements*. However, we have practical concerns that we believe should be addressed in a final SOP:

- The SOP should clearly define the types of payroll-related costs which should be capitalized. We believe there is the potential for inconsistency in practice as some companies may "fully load" payroll-related costs (e.g., payroll taxes, postretirement benefits, and other employee benefit amounts) while others may not. We believe that these costs should be capitalized as they are directly related to the project and that the final SOP should provide guidance on this issue.

- We believe that it would be impractical to apply the impairment criteria of FAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* to software assets. As capitalized software assets would generally not have identifiable cash flows, the impairment test would be determined at the entity level. As long as the entity's total cash flows (undiscounted and without interest charges) is greater than the carrying amount of all such assets which are grouped in this manner, a company would never recognize impairment of these assets. Instead, we believe, that when the software is not performing its intended use (including both the nature and scope of its initial intended use), the asset should be considered impaired and measured at the lower of the amortized cost or fair value. The presumption should be software that is not performing as intended has no value (except for possible salvage value).

- Inconsistencies between this SOP and other accounting literature as it relates to the Year 2000 issue should be addressed. Specifically, we believe that costs related to Year 2000 upgrades may qualify as a significant upgrade as defined in this SOP and should be capitalized. However, this position is inconsistent with the Emerging Issues Task Force (EITF) conclusion reached in Issue 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000,* and we strongly believe that AcSEC should urge the EITF to revisit this issue in light of the SOP's conclusions.

Following are our views with respect to the specific issues raised in the ED:

1. Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We believe that internal-use software costs should be recognized as assets. We do not believe that companies should have the option to choose between asset recognition or expense treatment for these costs. If companies are allowed to choose among alternatives, the diversity in practice, which was the impetus behind this project initially, would continue to exist.

We do not expect that there would be substantial incremental costs in modifying our information systems to comply with the transition provisions of the ED.

2. This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We do not believe that the SOP should provide a "bright line" as a maximum period for amortization or require a particular method of amortization. Companies are better able to determine an appropriate amortization period and method based on their individual facts and circumstances.

3. Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

We do not believe that the impairment recognition criteria of FAS No. 121 is practicable for these types of assets. These assets would not have specifically identifiable cash flows, and accordingly, the impairment test would be determined at the entity level. Consequently, as long as the entity's total cash flows (undiscounted and without interest charges) is greater than the carrying amount of all such assets which are grouped in this manner, it would be extremely difficult to recognize impairment. Instead, we believe that internal-use software that is not performing its intended use should be written down to the lower of amortized cost or fair value. Further, the presumption should be that the fair value is zero, unless there is possible salvage value.

4. This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We do not believe that the technological feasibility criteria of FAS No. 86 should be applied to these types of costs. The application of the more stringent technological feasibility threshold as prescribed by FAS No. 86 to internally developed software projects would result in a far more significant portion of the costs (e.g., coding, testing) being expensed than we believe is appropriate.

We do believe, however, that implicit in the "probable" criteria of par. 20 of this SOP is that the software will have the technological capacity to perform its intended function within an entity's operating environment. We believe that this is a reasonable threshold for beginning capitalization of costs.

5. Is this proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Generally, we agree with the scope of the costs that should be capitalized under the SOP. However, the final SOP should clearly define the types of payroll-related costs which should be capitalized. We believe that some companies may capitalize payroll-related costs including pension, post retirement benefits, medical, etc. while others may not. We believe these costs should be capitalized as they are a direct cost of the software project and that the final SOP should provide guidance on this issue to eliminate unnecessary diversity in practice.

6. Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

The current guidelines are appropriate, however, we believe the final SOP should contain additional examples regarding certain subprocess costs that would be appropriate for capitalization. For example, guidance would be helpful on how to account for the costs related to the development of "conversion software" used to convert existing data to a new system to allow the new system to function as intended. One could conclude that since the conversion software only functions during a limited phase and has a relatively short life, it should be expensed. However, one could also conclude that this conversion system which is critical to the operation of the new internally developed system is a cost of implementation and should therefore be capitalized as part of the new internally developed system. We support the latter conclusion and suggest that appropriate guidance be added to the SOP.

7. Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be used both internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

We agree with the approach as outlined in the SOP. Companies should be required to follow either the guidance in FAS No. 86 or this SOP for a given software project, but not both.

8. The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

The SOP's guidance on distinguishing between upgrades or enhancements and maintenance activities is appropriate. We believe that a modification to internal use computer software that results in significant additional functionality should be capitalized.

We also believe that modifying current information systems to comply with the Year 2000 issue qualifies as a significant upgrade as defined in this SOP and that these costs should be recognized as an asset. However, the guidance in the SOP runs counter to the position reached in EITF Issue 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000,* and we strongly suggest that AcSEC discuss with the EITF the need to reconsider the conclusions reached in that Issue.

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Again, we thank you for the opportunity to present our comments on the SOP. We would be pleased to discuss our comments further with members of AcSEC or the AICPA staff. If you have any questions, please do not hesitate to contact me.

Sincerely,

Robert J Price

Controllers Division
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Pfizer

Herbert V. Ryan
Vice President—Controller

April 14, 1997

Mr. Daniel J. Noll
Technical Manager
Accounting Standards Division
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1211 Avenue of the Americas
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Subject: Exposure Draft of Proposed Statement of Position on Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (File 4262)

Dear Mr. Noll:

Pfizer welcomes the opportunity to comment on the proposed Statement of Position (SOP), ***Accounting for the Costs of Computer Software Developed or Obtained for Internal Use***, dated December 17, 1997.

Pfizer is a research-based, global health care company whose products are available in over 150 countries. The Company's 1996 net sales were $11 billion and its assets are approximately $15 billion.

The Company is in general agreement with the Exposure Draft and we welcome its issuance by providing clarification on this topic and eliminating the diverse accounting practices that currently exist. Our comments are summarized below and more fully discussed in the attached document.

Specifically, we agree that the costs of computer software developed or obtained for internal use be recognized as assets and support the decision of not permitting entities to have the option of capitalizing or expensing such costs. We are also in agreement that the proposed SOP not specify a maximum period for amortization or methods of amortization. We believe that the decision as to a company's policies on this should be the responsibility of the entity with the concurrence of its outside auditors.

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We do suggest revisions to the proposed SOP in two areas, as follows:

- We believe that the SOP should require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing the costs of computer software developed or obtained for internal use. We agree with the FASB's Basis for Conclusions in Statement No. 86 and believe that it also applies to internal-use computer software. We support a more conservative approach than proposed in the SOP due to the higher risk inherent in the design of computer software than in the design of other long-lived assets and the greater potential for write-offs.

- We are in agreement that impairment of internal-use computer software assets be assessed, measured and recognized but believe that the guidance provided by FASB Statement No. 121 is not necessary, or even appropriate, for capitalized computer software. We believe that the assessment criteria in FASB Statement No. 121, utilizing cash flow analysis, would be difficult, if not impossible, to apply to internal-use computer software assets. The future cash inflows expected to be generated by the software and the future cash outflows expected to be necessary to obtain those inflows are not easily determinable, if determinable at all. We also believe that the use of fair value in determining the amount of a write-off, as used in FASB Statement No. 121, generally would not be applicable to capitalized software costs. It seems likely that internal-use computer software that is not expected to provide substantive service potential for the entity would not be marketable to another entity. Similarly, we believe that software, that is under development and is not expected to be completed, generally will not have any fair value to the entity or be marketable to other entities. We are of the opinion that in both instances the carrying amount be written off.

The attached document includes a further discussion of our comments on the issues raised in the "Areas Requiring Particular Attention by Respondents" section of the Exposure Draft.

Very truly yours,

H. V. Ryan

H. V. Ryan

att.

cc: Mr. D. L. Shedlarz, Senior Vice President - Chief Financial Officer

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AcSEC ED - "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Pfizer Inc Response to "Areas Requiring Particular Attention by Respondents"

Issue 1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We are in general agreement that the costs of computer software developed or obtained for internal use be recognized as assets. We agree that software meets the definition of an asset as contained in FASB Concepts Statement No. 6, *Elements of Financial Statements*: "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events".

In the interest of consistency among enterprises, entities should not have the option to capitalize or expense software costs. Software costs greater than an entity determined materiality level should be capitalized. The expensing of software costs below an entity established threshold will assure that the benefits of reporting capitalized software costs exceed the costs of reporting. The costs of reporting include the costs of identifying and subsequently tracking and amortizing capitalized software costs.

Issue 2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We are in agreement that the SOP not specify a maximum period for amortization or methods of amortization. While we are of the opinion that amortization periods should be relatively short due to rapidly changing technology, we believe that the decision as to a company's policy on the amortization period for software and on the method of amortization should be the responsibility of the entity with the concurrence of its outside auditors.

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AcSEC ED - "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Pfizer Inc Response to "Areas Requiring Particular Attention by Respondents"

Issue 3: Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?* If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure impairment of internal-use computer software assets?

We are in agreement that impairment of internal-use computer software assets be assessed, measured and recognized but believe that the guidance provided by FASB Statement No. 121 is not necessary, or even appropriate, for capitalized computer software. The proposed SOP provides adequate examples of possible impairment of operational software, as well as examples of the indications that software being developed is no longer expected to be completed and placed in service.

We believe that the assessment criteria in FASB Statement No. 121, utilizing cash flow analysis, would be difficult, if not impossible, to apply to internal-use computer software assets. The future cash inflows expected to be generated by the software and the future cash outflows expected to be necessary to obtain those inflows are not easily determinable, if determinable at all. We believe that, if the internal-use computer software asset is not expected to provide substantive service potential, the asset be considered impaired and its carrying amount written off. Similarly, accumulated costs should be written off when software being developed is not expected to be completed and placed in service.

Under FASB Statement No. 121, once it has been determined that impairment exists, it is measured by comparing the carrying amount to the asset's fair value. We do not believe that it is possible to assign a fair value to the asset as required by FASB Statement No. 121. Fair value is defined in that Statement as the amount at which the asset could be bought or sold in a current transaction between willing parties. It seems likely that internal-use computer software that is not expected to provide substantive service potential for the entity would not be marketable to another entity. We believe that an entity will either use the software as intended and carry the asset at amortized cost or will not have use for the software at all and it will have no fair value. Similarly, we believe that software, that is under development and is not expected to be completed, generally will not have any fair value to the entity or be marketable to other entities. Thus, the accumulated balance should be written off. To the extent an entity can demonstrate that the software is marketable (i.e., that there is a ready and willing buyer), then the fair value could be offset against the write-off. We do not believe that there could be a general presumption of marketability such as with a machine or a building.

AcSEC ED - "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Pfizer Inc Response to "Areas Requiring Particular Attention by Respondents"

Issue 4: This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We believe that the SOP should require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing the costs of computer software developed or obtained for internal use. Per FASB Statement No. 86, *"the technological feasibility of a computer software product is established when the enterprise has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements"*. We agree with the Board's Basis for Conclusions in FASB Statement No. 86: *"In defining those activities in the software product process that are research and development, the Board used the following definition of development presented in paragraph 8 of Statement 2 as a frame of reference: . . . the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants".* Further, we are in agreement with the Board's additional consideration and conclusions in the FASB Statement No. 86 Basis for Conclusions: *"the Board concluded that, until technological feasibility can be objectively established, the future economic benefits from such coding and testing activities are too uncertain to qualify for recognition as an asset and should be classified as research and development"* and believe that this applies to internal-use software as well.

AcSEC's basis for concluding that an entity should not have to meet technological feasibility criteria before it begins capitalizing computer software costs is that internal-use computer software should follow the capitalization principles for long-lived assets, such as construction of facilities. AcSEC concludes in the proposed SOP that a requirement of technological feasibility is only appropriate for an inventory model for software that is sold, leased, or otherwise marketed.

We are of the opinion that there is more risk inherent in the design of computer software than in the design of other long-lived assets. Therefore, in concurrence with paragraph 8 of FASB Statement No. 2 quoted by the Board in its Basis for Conclusions in FASB Statement No. 86, and in support of a more conservative approach due to the higher risk of potential write-offs, we believe that technological feasibility should be required in this SOP using the same criteria as in FASB Statement No. 86.

AcSEC ED - "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Pfizer Inc Response to "Areas Requiring Particular Attention by Respondents"

Issue 5: Is this proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

We are in agreement with the guidance provided in the proposed SOP.

Issue 6: Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

Pfizer generally uses software for internal purposes only. We are in agreement with the guidance provided in the proposed SOP.

Issue 7: Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should these costs be allocated?

Pfizer generally uses software only for internal purposes. We are in agreement with the guidance provided in the proposed SOP that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. We agree with the approach in the proposed SOP that both the SOP and FASB Statement No. 86 should not be applied to the same software costs.

Issue 8: The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is the guidance operational?

We are in agreement with the guidance provided in the proposed SOP.

WELLS FARGO & COMPANY

FRANK A. MOESLEIN
Executive Vice President
and Controller

April 15, 1997

343 Sansome Street
San Francisco, CA 94163

Mr. Daniel Noll, Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 4262
Proposed Statement of Position
"Accounting for the Costs of Computer Software
Developed or Obtained for Internal Use"

Wells Fargo & Company is a bank holding company whose principal subsidiary is Wells Fargo Bank, NA. We appreciate this opportunity to comment upon the AICPA's Exposure Draft (ED) on accounting for the costs of computer software. All references to paragraph numbers are to those in the ED, unless another source is specifically indicated.

Wells Fargo objects to the proposal to require all (nongovernmental) entities to perform the assessment of costs incurred for computer software developed for internal use, as proposed in the ED, and to capitalize software costs that meet the criteria. We believe that the situations where the case for capitalization is convincing is the exception, not the rule. However, as the price for the exceptional situation, all entities will now incur incremental costs to accommodate those limited situations, even if all software costs in a given period are ultimately determined to be expenses under the criteria.

The incremental costs consist of changing or adding to management's existing monitoring practices in order to capture specified costs not only by project but also, by component or module (¶9) and by stage. This will include the use of management time to assess when efforts are in one of the various categories and to debate the general definitions that delineate the accounting treatment (¶10, ¶16, etc.) and define the undefined terms necessary to apply the proposal. Costs will also arise from the need to establish and maintain internal controls, for example, to determine employee time is properly coded to projects that are in a capitalizable category, since this information generally cannot be recreated if not properly captured as events occur.

The incremental costs of compliance, in our view, do not provide a proportionate increase in "information value" to shareholders and users of financial statements. Rather, this is primarily an addition to the accounting burden. So that users of financial statements can be assured of the treatment given these types of expenditures (resolve concerns about diversity in practice), all such costs should be expensed as incurred (as the service is rendered). Since management can control when services are rendered, the accounting cost related to obtaining software is reduced to that of the typical and existing budget process.

Given the current level of use of electronic data processing (for internal use, as defined in the ED), "software" development is an ongoing, core expense for most businesses. These efforts largely create value for future periods regardless of whether they are upgrades, enhancements or new applications, but nothing is gained by trying to convert that philosophy into accounting measurements based on traditional tangible or fixed asset accounting. Furthermore, we are concerned by the precedent that will be set if this ED is adopted. Analogies will be made to it to support capitalizing other consulting and employee compensation (soft) costs that "support the operations of the company" (¶58) and benefit future periods, but are not currently capitalized or deferred. There is no need to open the door to these kinds of debates. In SOP 93-7 (Advertising Costs), AcSEC has already rejected the idea that such costs are assets unless they can be directly tied to specific, incremental revenues. Therefore, we believe that AcSEC should reaffirm that general approach for software costs (FAS 86, "*Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,*" adequately delineates situations where software costs should not be immediately expensed).

We agree with AcSEC's conclusion that no additional disclosure (beyond APB Opinion No. 22) is needed.

We believe the additional areas for which comments are specifically requested in the ED, which we have not commented on, are indicative of the subjectivity and difficulty that will arise from capitalization. These are additional examples of matters which in turn distract management from running the business in order to address accounting issues that need not exist in the first place. Thus, we have not provided comments beyond the core issue. We appreciate the effort that AcSEC has devoted to this topic in order to deal with questions raised about the proper accounting treatment. AcSEC has documented that a discussion of how software should be accounted for was necessary. And, we believe AcSEC has provided a valuable service by framing the issue and providing a forum for due process. Having seen the support for capitalization, we do not find it compelling. The analogy to the conventional interpretation of the definition of "assets" is strained. Therefore, if a decision is needed on this matter, then this is an ideal opportunity to take the route that supports simplicity, consistency and cost effective administration of the accounting process.

Thank you for the opportunity to present our views. We will be pleased to discuss any of these issues or respond to questions you may have with respect to our comments.

Sincerely,

Frank A. Morelli

1221 Avenue of the Americas
New York, NY 10020-1095
Tel 212 512 4819

Thomas J. Kilkenny
Vice President
and Controller

The McGraw·Hill Companies

April 14, 1997

Mr. Daniel Noll
Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File Reference 4262
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

The McGraw-Hill Companies appreciates the opportunity to comment on the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

We support the American Standards Executive Committee's (AcSEC) proposal to capitalize the costs to develop or purchase software for internal use. Our preference would be to permit capitalization but not require it because of the more conservative policy to expense these costs. However, we do recognize that AcSEC's intent is to reduce diversity in practice for comparability among companies and for this reason support required capitalization.

We are concerned about the proposed use of the conceptual formulation stage as the start of deferral of costs. We believe that the technological feasibility threshold prescribed by Financial Accounting Standards Board (FASB) Statement No. 86 should be applied to internal use computer software as the starting point for capitalization. We don't believe that there should be two standards, one for software to be marketed and one for internal use. The lower threshold will result in more research and development costs ending up in the balance sheet.

With regard to capitalizable costs, we believe that only incremental, direct costs should be capitalized. These costs would include outside consultants and professionals, employees hired for a specific project but will either be terminated at its completion or used elsewhere within a company, purchased software and other incremental costs directly related to a project. The inclusion of costs that are not incremental would only be appropriate to an inventory model. For this same reason, we also agree with the proposal that general andadministrative costs, overhead costs and training costs should not be capitalized.

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We are also concerned about the proposed application of FASB Statement No. 121 for determining impairment. Under Statement No. 121, companies are required to estimate future cash flows to determine if an asset is impaired, but there are no cash flows directly associated with internal use software. In practice, we believe that impairment would be recognized when the decision is made to replace the software earlier than anticipated.

With regard to the subsequent sale of internal use software, the SOP would prohibit any revenue recognition until all capitalized costs were recovered. We know of no conceptual basis for this proposed requirement. It appears that the intent is to penalize a company because it has subsequently determined that it could market its internal use software or, perhaps, in anticipation that some companies would account for software costs under the proposed SOP for software they had planned to sell. We believe the better approach is to apply the technological feasibility threshold for capitalization under Statement No. 86 and to only permit the capitalization of incremental, direct costs.

Sincerely,

Thomas J. Kilkenny

April 17, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

SUBJECT: **Exposure Draft for the Proposed Statement of Position "Accounting For the Costs of Computer Software Developed or Obtained for Internal Use"**

The Corporate Financial Reporting Department for Motorola, Inc. welcomes and appreciates the opportunity to express its views relative to the Accounting Standards Executive Committee's Exposure Draft for "Accounting For the Costs of Computer Software Developed or Obtained for Internal Use" dated December 17, 1996.

Issue #1 Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We believe entities should have the option to either capitalize or expense the costs incurred for internal use software. Each entity should be able to establish the thresholds at which capitalization would begin. The proposed SOP is requiring all internal use software to be capitalized as long-lived assets. Given the ever-changing technological environment, we do not believe all internal use software should be recorded as amortizable, long-lived assets. If an entity expects to derive benefits from such software for an extended period of time, it will invest considerable funds in acquiring or developing the software. Only after this point should the software be deemed long-lived and be subject to the proposed SOP.

We believe incremental costs would be incurred with the capitalization of such expenditures. However, incurrence of these costs was not a key factor in our overall position that entities should have flexibility based on their business needs and specific aspects of the software developed for internal use to either recognize the costs as period expense or long-lived assets.

Issue #2 The proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We support the Committee's conclusion that the proposed SOP should not specify a maximum amortization period as each entity is in a better position to determine an appropriate useful life and amortization method.

Issue #3 Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

We believe FASB Statement No. 121 should only be applied to internal software acquisitions or developments recorded as amortizable, long-lived assets. Impairment becomes more of an issue for such large software acquisitions or project developments occurring over extended periods of time. Therefore, the guidance of Statement 121 would be applicable. As such, the proposed SOP need not provide further guidance other than what is prescribed in paragraphs 28 and 29.

Issue #4 This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We believe technological feasibility criteria should be met only for software developed, as opposed to obtained, for internal use. The criteria in Statement 86 mirrors the Program Instruction Stage of paragraph 16 of the proposed SOP. Therefore, we believe the second criteria for capitalization in paragraph 20 should require capitalization only after the completion of the Program Instruction Stage when technological feasibility has been established.

Issue #5 Is the proposed SOP too broad or too narrow in the kinds of costs that would be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

We agree with the kinds of costs the proposed SOP includes for and excludes from capitalization.

Issue #6 Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

We believe the guidance to determine whether computer software is for internal use is sufficient.

Issue #7 Software is sometimes developed or obtained for both internal use and external marketing. The proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in the proposed SOP and FASB Statement No. 86 when the costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in the proposed SOP that requires an entity to follow the guidance in either the proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

We agree with the Committee's conclusion that an entity should either follow the guidance

in the proposed SOP or Statement 86, but not both. In addition, we agree with the proposed SOP's requirement that an entity which capitalizes costs of internal use software and subsequently sells the software should defer the earned revenue until the capitalized software costs are fully recovered.

Issue #8 The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

We believe the guidance distinguishing between computer software activities which are upgrades/enhancements and maintenance is operational.

Again, we thank the Committee for the opportunity to present our comments on this proposed SOP.

Sincerely,

/s/ Ken Johnson
Ken Johnson
Corporate Vice President,
Controller and Director of Audit

Author: MIME:michaelg@usaa.com at INTERNET
Date: 4/16/97 6:29 PM
Priority: Normal
TO: Daniel J. Noll at AICPA3
CC: -:Michaelg@usaa.com at INTERNET
Subject: Response to Exposure Draft, Accounting for the Costs of Comp

---------------------------------- Message Contents ----------------------------------

Dan:

I have provided our (USAA, 9800 Fredericksburg Road, San Antonio, TX 78288) response to your solicitation for comments below:

(1) ▒Should the costs of computer software developed or obtained for internal use be recognized as assets?
▒
▒Yes. FASB Statement of Concepts 6, paragraph 25 states that: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Historically, internally developed software has provided future economic benefits. Additionally, internally developed software is controlled by the entity that developed it. What differentiates software from more tangible property like real estate or equipment is the fact that it is intellectual property. As the world economy migrates to a more service oriented economy an asset of this type will become more common.

(1) ▒Should entities have the option to capitalize or expense such costs?

▒No. Companies should be required to capitalize these costs if they provide a future economic benefit. The impetus for writing this SOP was because of the diversity in practice among reporting companies. According to FASB Statement of Concepts 2, paragraph 112 states: "The difficulty in making financial comparisons among enterprises because of the use of different accounting method has been accepted for many years as the principal reason for the development of accounting standards." Having all companies capitalize this software establishes consistent application of accounting information which is very useful when benchmarking and comparing companies.

Do the benefits of reporting those costs as assets exceed the costs of such reporting?
▒
▒Yes. Depending on the cost of the software. Most companies have a fixed asset system in place and if a company has an internal information services area, they usually have project tracking that monitors each phase of software development. Therefore, the costs associated in tracking and reporting capitalization of software are minimal if the costs of the software exceeds a certain dollar threshold.

What are the costs of reporting?

▒▒▒Primarily administrative.

(2)▒This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required? Paragraph 75 provides the basis for AcSEC's conclusions.

No. There are many types of software with varying degrees of useful life. There may be some software that exceeds the "normal" useful life expectancy of perhaps your average software. This may occur with a major development project that develops a system that is expected to be in place for a number of years. Each company is the best judge on the expected useful life of the software placed in service.

(3)▒Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived

Assets to Be Disposed Of?

Yes.

If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment?

In general, yes. However, in example 4 in paragraph 28 on page 11 it is unclear as to which costs are impaired. A project may exceed the amount originally expected to develop or modify the software but that does not necessarily mean that impairment should be recognized.

If not, how should entities recognize and measure the impairment of internal-use computer software assets?

N/A

(4) This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed) before it begins capitalizing qualifying costs.

Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?

No. A company should be able to capitalize costs after the Preliminary Project Stage described in paragraph 16. At this point of the project, all alternatives have been researched and reviewed. If a decision to proceed to the Program Instruction Stage is reached, also described in paragraph 16, it is probable that the project will proceed through the Implementation Stage and management commits resources to that project. A company should not have to wait until the Implementation Stage to begin capitalizing costs.

If so, what are those criteria?

N/A

(5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets?

No.

Why?

Paragraph 26 is fairly explicit regarding what costs should and should not be capitalized.

What costs should be included or excluded?

N/A

(6) Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use?

Yes.

Is this guidance appropriate?

Yes.

Why?

The guidance is appropriate because both characteristics of paragraph 11 must be met for software to be categorized as internal-use software.

(7) Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met,

the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both?

Yes.

If not, how should those costs be allocated?

N/A

(8) The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Yes. However, upgrades and enhancement projects will have to be carefully monitored to ensure that they truly add significant functionality to the software. We foresee that there may be opportunity for abuse if not monitored on an individual basis.

If you have any questions or need additional information, please give me a call at 210-498-7329.

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

IN REPLY REFER TO:
1600E1

April 16, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The staff of the Accounting and Audits Division ("Division") of the FCC's Common Carrier Bureau has reviewed with great interest the Accounting Standards Executive Committee's ("AcSEC") Exposure Draft Proposed Statement of Position ("SOP"), regarding Accounting for the Costs of Computer Software Developed or Obtained for Internal-Use. The Division has responsibilities for maintaining the Uniform System of Accounts for telecommunications companies, which is the regulatory accounting system prescribed by the FCC for telephone companies. The Division has a particular interest in accounting and reporting matters that have a significant impact on the operations and accounting of regulated telephone companies. This issue is very important to the FCC because telephone companies have significant investment in computer equipment associated with digital switches. If companies are required to revise their accounting procedures to the extent that software associated with their switches and other network components is capitalized, their shifts in computer software expense may be significant.

The Division staff concurs in most respects with the proposed SOP and proposes minor additions to the proposed SOP guidelines. These proposals represent the opinion of individual members of the Division staff and do not convey the position of either the FCC or its Common Carrier Bureau.

We agree with the proposed SOP that the costs of computer software developed or obtained for internal use should be recognized as assets based on AcSEC's conclusions -- that the costs are specifically identifiable, have determinate lives, relate to probable future economic benefits and meet the recognition criteria of definitions, measurability, relevance, and reliability. We also agree that entities should not have the option of capitalizing or expensing such costs. The purpose of the proposed SOP is to develop authoritative guidance in order to minimize the lack of consistency and uniformity that currently exists. We believe that, for telephone companies, the benefits of reporting those costs as assets, such as increased consistency and comparability of accounting information, exceed the costs of such reporting. We believe that, under the proposed SOP, telephone companies will not incur additional reporting costs, because reporting costs will not vary appreciably whether the software is expensed or capitalized.

We recommend that the proposed SOP specify a maximum recovery period for the amount capitalized. We recommend that the guidelines for specifying a maximum recovery period of amortization be generally based on the life of the associated hardware/equipment. For example, under such guidelines, the maximum amortization period for digital software included in a telephone switch would not exceed the useful life of the telephone switch which is approximately 15 years. Similarly, the software maintained on general purpose computers would not exceed 5-7 years which is their current useful life. We believe that, for telephone companies, the useful life of software generally corresponds to the useful life of the associated hardware/equipment. Again, we believe that establishing uniform accounting guidelines will result in greater consistency and comparability of accounting information among entities.

The guidance provided in the proposed SOP that is used to distinguish computer software upgrades or enhancements from maintenance should be more precise and should establish a standard based on increased functionality. We recommend that the proposed SOP be revised to clarify that if the new software provides <u>new</u> features or functions, it should be regarded as an upgrade and capitalized. If, however, <u>new</u> features or functions are not provided, the software should be regarded as maintenance and expensed. For example, if a telephone company replaces the switch software with new software that adds features such as call waiting or call forwarding, the cost of the new software would be capitalized. On the other hand, if the company replaces the switch software with new software that provides essentially the same functions and features as the old software, the cost would be expensed. We also recommend that the proposed SOP be revised to state that the amortization period for all such upgrades or revisions be equal to the remaining life of the associated telephone switch including the initial software. The proposed SOP in Appendix A provides examples that illustrate whether computer software should be classified as internal-use. We recommend that the proposed SOP be revised to include an appendix with examples that illustrate computer software activities that should be classified as upgrades as well as those that should be classified as maintenance activities.

In conclusion, we fully support the proposed SOP and believe that it will provide consistent and uniform accounting guidance. We appreciate the opportunity to provide our comments. If you have any questions concerning this matter, please contact Brett Kissel at (202) 418-0391 or Tom Quaile at (202) 418-0838.

Sincerely,

Kenneth Moran
Chief, Accounting and Audits Division

A4405

NORTHWEST AIRLINES

April 16, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

We have reviewed the exposure draft of the proposed Statement of Position (SOP) *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. We appreciate the opportunity to respond to this proposed SOP. In general, we support the SOP and believe it will enhance financial reporting. Our comments on the issues specifically raised and other aspects of the exposure draft are summarized below.

Issue 1 - In our view, computer software developed or obtained for internal use should be recognized as an asset. Entities should not have the option to capitalize or expense such costs, as this would diminish consistency and comparability in practice. However, we believe the SOP should specifically state that entities may select a reasonable dollar threshold under which project costs need not be capitalized. We believe the benefits of capitalizing and reporting software costs will exceed the costs of such reporting provided that reasonable thresholds may be established.

Issue 2 - We support a maximum amortization period of eight years. This would provide uniformity and establish some level of conservatism. Recognizing the rapid advancements in technology, it is generally not reasonable to assume the useful life of computer software will extend into the distant future. Also, we believe that amortization of a given software component/module should begin when testing is substantially complete and the component is capable of performing a function. If functionality is dependent on the completion of other components, amortization should not begin until such components are ready for their intended use. Finally, we recommend that the SOP advocate straight line depreciation, as the service utility of a software asset is generally constant over its useful life.

Issue 3 - We believe the impairment of software assets should be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*. We believe FASB Statement No. 121 provides sufficient guidance for this accounting.

Issue 4 - We agree with the AcSEC position that the technological feasibility criteria applied in FASB Statement No. 86 is not applicable to computer software developed or obtained for internal use. Furthermore, we concur that cost capitalization should be initiated based on the criteria stated in paragraph 20 of the SOP.

Issue 5 - We believe that additional guidance is needed regarding the type of costs that should be capitalized. We recommend that the SOP be expanded to state that:

- o The payroll-related costs (vacation, sick, etc.) of data processing professionals should be capitalized only if such professionals are largely dedicated to the development project.

- o The payroll and payroll-related costs of "user" personnel (e.g. user testing) should be capitalized only if the users are fully dedicated to the development project and such costs are incremental.

- o The costs of incremental training required by data processing professionals to develop and implement the computer software should be capitalized.

- o The costs to develop formal user training programs and permanent training documentation that has a life expectancy equal to that of the computer software should be capitalized.

- o The incremental costs to install the computer software into the production environment, including the costs to convert/transfer data from old to new systems should be capitalized.

We also recommend that the SOP identify costs that should not be capitalized. In our view, the SOP should state that:

- o The costs of initial project scoping, including system requirements definition, should not be capitalized.

- o Corporate overhead costs, including general overhead of the IS function (routine training of IS personnel, hardware depreciation/rental expense, etc.) should not be capitalized.

- o The costs of training time (trainer and trainee) to provide instruction on use of the computer software should not be capitalized (because future periods benefitted cannot be determined).

Issue 6 - We believe the SOP provides sufficient guidance to help entities determine whether computer software is for internal use.

Issue 7 - We agree that costs for a given computer software project should not be allocated between internal-use software and software to be marketed. Guidance in the proposed SOP should be applied at the software component or module level to determine which condition is *most* applicable. The corresponding accounting treatment prescribed by the proposed SOP or FASB Statement No. 86 should then be followed.

Issue 8 - We agree that maintenance activities should be expensed as incurred and significant upgrades and enhancements should be capitalized. However, we believe that additional guidance is needed to adequately distinguish between maintenance and enhancement activities. We suggest that the SOP be expanded to include the following:

- o Once a system is installed and operational, costs should be considered *betterments*, and hence capitalized, only if both of the following are met:

- The system's functionality is substantially improved.
- The modification effort/cost is clearly incremental to the normal/historical level of support.

- o If an activity has characteristics of both a betterment and normal maintenance/support, such activity should be treated as period expense.

- o Costs to develop and/or install a new release of existing software should be expensed, unless functionality is significantly improved and project costs are both incremental and significant.

In keeping with the spirit of FASB Statement No. 121, we believe the SOP should specifically require write-off of value associated with components/modules of the existing software that have been replaced or redesigned by the upgrade or enhancement.

Finally, we recommend that the SOP specifically state how conclusions reached in Emerging Issues Task Force Issue No. 96-14, regarding year 2000 costs, are consistent with the general provisions of the SOP. Perhaps footnote 2 on page 14 should be expanded to say that year 2000 costs are generally incurred to maintain existing functionality, and thus, should be expensed. Software life extensions resulting from year 2000 work are generally incidental to the maintenance of existing functionality.

Other Issues

Scope - We believe conversion tasks are an integral part of system implementation and that accounting for such costs should be included within the scope of the proposed SOP. Capitalization of these costs should generally follow the guidelines stated in paragraph 26, *Capitalizable Costs*, of the SOP. It is our opinion that costs to convert data from old to new systems represent installation costs that are required for the new system to perform its intended function and generate incremental benefits. This is consistent with fixed asset accounting, where all costs incurred to purchase, install and ready an asset for service are capitalized.

Disclosures - In our view, the SOP should specifically require disclosure of total computer software costs capitalized during each period for which an income statement is presented and the associated amortization period for such costs.

Again, we appreciate the opportunity to offer comments on the proposed SOP. If we can provide further information regarding our comments, please call Mark Osterberg at 612-726-7298.

Sincerely,

Mark W. Osterberg
Vice President & Chief Accountant
Northwest Airlines, Inc.

UNITED STATES
TELEPHONE
ASSOCIATION

USTA
100 Years
1897-1997

April 16, 1997

Mr. Daniel Noll
Technical Manager Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: AICPA AcSEC File 4262

Dear Mr. Noll,

The United States Telephone Association (USTA) is the major trade association of the local exchange carrier industry. With approximately 1,100 telephone companies in its affiliation, USTA members currently provide nearly all access lines in the United States. We respectfully submit comments on the Accounting Standards Executive Committee's (AcSEC) Exposure Draft (ED) of the Proposed Statement of Position (SOP), Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, dated December 17, 1996. This letter outlines USTA's general concerns and suggestions and provides a brief summary of the Attachment which details USTA's comments on the eight specific issues requested by this ED. These comments demonstrate that:

- the accounting for the cost of internal-use software proposed by SOP is contrary to the current predominant industry practice of expensing

- there currently is ample authoritative guidance addressing the accounting for internal-use software without this SOP

- this SOP is at odds with Generally Accepted Accounting Priniciples (GAAP) currently prescribed for internal-use software

- it is virtually impossible to assign accurate economic lives to internal-use software

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- application of SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of to internal-use software costs capitalized under this SOP is not viable

- the accounting proposed by this SOP for internal-use software will not provide more meaningful financial data

- the accounting for internal-use software proposed by this SOP will be costly to implement

Also, USTA has added, for clarity, specific comments on the accounting for internal-use software prescribed by the FCC for the telecommunications industry **(see Item 9 of Attachment)**.

This ED (consistent with most SOPs) requires implementation prospectively for fiscal years beginning after December 15, 1997 and is applicable to costs incurred in those fiscal years, including costs of those projects in progress upon initial application of the SOP. Further, this ED requires that costs incurred prior to the initial application of the SOP, whether capitalized or expressed, will not be adjusted. This SOP proposes to change the predominant industry practice of expensing internal-use software, which follows current GAAP. Since the SOP requires entities to discontinue this predominant accounting practice and capitalize the cost of internal-use software, this change by definition is considered a change in accounting principle.

This prospective implementation for a change in accounting principle is contrary to Accounting Principles Board Opinion No. 20, Accounting Changes (APB No. 20). APB No. 20 states that "a change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. A characteristic of a change in accounting principle is that it concerns a choice from among two or more generally accepted accounting principles." Paragraph 18 states, "the Board concludes that most changes in accounting should be recognized by including the cumulative effect, based on a retroactive computation, of changing to a new accounting principle in net income of the period of the change..." Thus the ED appears to be at odds with current GAAP requirements for reflecting changes in accounting principle.

The Financial Accounting Standards Board (FASB) would normally issue an exposure draft to promulgate a change in accounting principle. An ED by the FASB would provide complete details on disclosures required, afford a full due diligence process, and collect complete cost / benefit facts prior to implementation. A change in accounting principle should be accounted for by recording the cumulative effect of this change in the financial statements, thus making the financial statements comparable from an industry and analyst standpoint. This SOP, with prospective application, would make the financial statements incomparable and will lead to inconsistent financial data for "soft assets" currently under development (i.e., only partial recognition of these "soft assets" on the balance sheet).

This treatment will also result in further non-comparability of software costs in the financial statements and the increased amount of "soft assets" on the balance sheet would lead to increased skepticism on what value to put on a company. If the accounting proposed by this ED is not treated as a change in accounting principle, cost of multi-year projects will be accounted for as both capital and expense (i.e., capital in the period of adoption, but expense in the prior period). If assigning meaningful lives to undivided software projects is an arbitrary exercise, assigning meaningful lives to portions of projects is a futile exercise.

In addition to the change in accounting principle for internal use software pointed out above, USTA's detailed response to the eight specific issues outlined by the ED are summarized below.

First, the accounting proposed by this SOP for the cost of internal-use software is contrary to existing GAAP (i.e., the predominant industry practice of expensing these costs). Also, USTA's comments provide evidence that the telecommunications industry has consistently followed the predominant practice of expensing costs of internal-use software in the period incurred.

Second, the stated need for this SOP is the perceived lack of authoritative literature on the accounting for the cost of software obtained or developed for internal-use and the growing magnitude of these software costs. USTA's comments point out that the FASB provided specific guidance on this issue when it issued Statement of Financial Accounting Standard No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (SFAS No. 86), in August 1985. Appendix B, Paragraph 26 of SFAS 86 states in essence that the predominant industry practice at that time was to expense the cost of internal-use software, and the Board did not find that practice unacceptable. USTA's comments point out that this authoritative guidance is clear and that this change in accounting for the cost of internal-use software proposed by this SOP is not needed.

Third, USTA's comments address the AcSEC's belief that internal-use software costs should be capitalized because the software is used for more than one accounting period. USTA's position (similar to all the comments on research and development costs in SFAS No. 2 Appendix B) is that the life of software cannot be accurately measured or determined. USTA's comments are consistent with AT&T's position on this issue in its comments submitted to the FCC in 1985 and is consistent with the Software Publishers Association's (SPA) position on this issue expressed in its letter to the FASB Chairman dated March 14, 1996. Although developed over a decade apart, their positions are the same; the future economic benefits associated with software are tenuous and of a highly questionable nature because the periods benefited are indeterminable; software is in a continuous state of change; and the pace of that change is accelerating. Therefore, USTA believes these "soft costs" should continue to be expensed and should not be deferred on the balance sheet to future periods.

Fourth, USTA's comments address the measurement of the impairment of internal-use software capitalized under the accounting proposed by this SOP. USTA points out that the accelerated pace of new software development, coupled with the rapid rate of change in software, and the lack of any identifiable software related revenue stream make it virtually impossible to apply new measurement criteria in SFAS No. 121. These same factors (accelerated pace of development and rapid pace of change) make it impossible to develop new standards to measure the impairment of internal-use software. USTA believes that one cannot apply SFAS No. 121 to "soft assets" which have been assigned arbitrary economic lives.

Finally, our comments address the relevancy issue by providing an analysis of the impact this proposal would have had on industry financial data if software purchased (note that internally developed software costs are not known) for internal use had been capitalized for the period 1-1-93 through 12-31-96. This analysis shows, based on a three year amortization period, (three years is the arbitrary period used in the illustration) the change in accounting principle proposed for software by the SOP would have resulted in a decrease in the industry level of software expense of under two tenths of one percent for 1996. Also, capitalization of software purchased for internal-use would have resulted in net capitalized "soft assets" of about $2.6 billion, which is approximately two and a half percent of total industry net assets of $124 billion at 12-31-96.

USTA believes this proposed SOP is unnecessary. Its members currently follow the predominant practice of expensing the cost of internal use software. This practice continues to be the preferred accounting for internal-use software because the applications and technology for both network and non-network internal-use software is constantly changing. This practice has been incorporated into the FCC's Part 32 accounting rules as GAAP. Accordingly, USTA urges the AcSEC not to reverse the long standing predominant practice of expensing the cost of internal-use software in favor of the fixed asset model proposed by the ED. That model can only result in the capitalization of costs that, in terms of future economic benefits, are of a tenuous and questionable nature and if capitalized will be amortized over an arbitrary period because the life of the software is not readily determinable.

USTA will be pleased to discuss our comments or provide any additional information that you believe would be helpful. We thank you for the opportunity to comment on this proposed SOP.

Sincerely,

The United States Telephone Association
by

Porter E. Childers

Porter E. Childers
Executive Director,
Legal and Regulatory Affairs

The LTV Corporation

April 15, 1997

Mr. David Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: EXPOSURE DRAFT ON "ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE"

Dear Mr. Noll:

The LTV Corporation is pleased to offer its comments concerning this proposed Statement of Position. We support the conclusions reached in the Exposure Draft with the need for further clarification of some items.

The Exposure Draft states in paragraph 10 that "Accounting for costs of reengineering operations, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. Similarly, accounting for costs of converting data from old systems to new systems is excluded from the scope of this SOP." We believe, based on our experience, that reengineering and legacy system conversion costs are integral to the development of new software systems and as such, these costs, in most cases, cannot be segregated.

LTV believes that reengineering and converting legacy systems, although not currently considered part of the scope of the Exposure Draft, should be included. Reengineering and conversion of legacy systems to maximize the benefit and functionality of new software systems are an integral part of implementation and quite often a significant portion of the cost of the entire project. The significance of these costs and the inability to separate them from new software costs leads us to believe that the capitalization of these costs is the appropriate accounting treatment. The current diversity of practice related to the reengineering and conversion costs will continue without clarification. If these costs are not included in the scope of this SOP, we believe that more definitive clarification should be provided on the costs to be included.

We thank you for the opportunity to provide our comments on this Exposure Draft. If we can offer any assistance in further discussions on the Exposure Draft, please contact me directly at (216) 622-4583.

Sincerely,

George T. Henning
Vice President & Controller

Chicago, IL 60606
Office 312/750-5171

Ameritech®

Ronald G. Pippin
Director
Financial Accounting
Standards and Reporting

April 16, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Ameritech Corporation is pleased to submit its comments regarding the Accounting Standards Executive Committee (AcSEC) exposure draft of the proposed Statement of Position (SOP) that addresses the accounting for the costs of internal-use software. Ameritech is a communications company with annual revenues over fourteen (14) billion dollars and assets over twenty-three (23) billion dollars. As a communications company, Ameritech incurs significant costs each year to develop and purchase software that is necessary to provide communications services.

Ameritech does not agree with AcSEC's proposal that the costs of all computer software developed or obtained for internal use should be recorded as assets. We believe that a company should be allowed to capitalize or expense software costs based on its past experience and future expectations relative to the life span of the software and its intended use for the software. We further believe that the consistent application of an accounting policy by a company is more important than it is for every company to account for an item in the exact same manner as long as the accounting policy is disclosed in the financial statements.

We have generally expensed application software costs as incurred, although in those rare cases where the software meets extremely stringent criteria, software may be capitalized and amortized over a period not to exceed three years. Generally, this has only occurred for administrative-type software. We also capitalize initial operating system software and amortize it over the life of the asset it supports. In most cases we have trouble justifying that application software has a useful life beyond one year and, therefore, have adopted our current policy. Our policy has served us very well as the business has evolved.

We adopted our policy due to rapid changes occurring in computer technology and our inability to predict the time period over which the software will produce an economic benefit. AcSEC is forcing us to assign a life that we believe is completely arbitrary. This is especially true in the communications industry where technological changes are continually occurring. If a life were assigned it should be of a very short duration, probably three years or less. In these cases, we do not believe that the capitalization of such short-lived "soft" assets do anything to improve the quality of a company's financial information. We further believe that the costs to develop systems to identify, track and monitor software costs with such a short life would exceed the benefits obtained from capitalizing the costs. As a result, we believe internal-use software should be charged to expense as incurred.

The option to expense software is especially important when it is used to provide a revenue-producing competitive service to customers. It is very important that a company provide its services using current technology or it would be at a competitive disadvantage and risk the possibility of losing its customers. As a result, a company must continually upgrade its

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software, and each time it upgrades its internal-use software it most likely would have to record an impairment write-down if it capitalized all internal-use software.

Additionally, Ameritech does not agree with the proposal that enhancements and upgrades should be capitalized. We believe that this requirement, when combined with the requirement to capitalize all "initial" internal-use software as discussed in the preceding paragraphs, would lead to impairment write-downs on a regular basis. The additional costs to track the upgrades and monitor them for impairment would further reduce the benefits obtained.

It may be appropriate to capitalize internal-use computer software when the use of the software is not directly impacted by the effects of obsolescence or competition (e.g., administrative-type systems such as accounting or billing systems). In these cases, management can make the decision to continue to use the software even though there have been subsequent releases. As a result, there is a determinable life.

Ameritech also does not agree with the proposal that interest costs should be capitalized as part of internal-use software. We believe that interest costs are no different than general and administrative and other overhead costs. As stated in the proposed SOP, these costs relate to the period in which they are incurred and should not be capitalized.

To provide users of financial statements with information to make comparisons of financial results between companies, rather than requiring companies to capitalize all internal-use software, we believe the SOP should require some enhanced disclosures regarding internal-use software and companies should be permitted to make their own evaluation as to whether an asset has been created.

Finally, in a letter last year to the Financial Accounting Standards Board (FASB), the Software Publishers Association requested the FASB to reconsider the current accounting requirements for the costs of developing computer software created for license or sale as prescribed in FASB Statement No. 86. As AcSEC proceeds with its deliberations regarding their proposed SOP to capitalize internal-use software, we strongly urge that the conclusions from the proposed SOP should be coordinated with the FASB so that the results of the two projects can be codified into one comprehensive statement on software.

We appreciate the opportunity to express our views pertaining to this proposed Statement of Position.

Sincerely,

Ron Pippin

Ronald G. Pippin

William J. Healy
Executive Vice President and Comptroller

SUMMIT Bancorp

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April 16, 1997

Daniel Noll, Technical Manager
Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

Dear Sir:

Summit Bancorp (the "Company") is pleased to submit its views on the Exposure Draft of the Proposed Statement of Position (SOP), ***Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*** Summit Bancorp is a Princeton, New Jersey-based financial services organization with $23 billion in assets. The Company operates 370 traditional and in-store branches throughout New Jersey and eastern Pennsylvania and over 500 ATM's. Its major lines of business include commercial, retail and mortgage banking, investment management and private banking. These core businesses and non-bank subsidiaries offer a full array of financial services to individuals, businesses, not-for-profit organizations, government entities and other financial institutions.

Respondents are requested to respond to specific questions. Summit Bancorp's responses are as follows.

Question One asks if computer software developed or obtained for internal use should be treated as an asset. We agree that treatment as an asset is correct when the expense is significant. An entity incurs the expense of purchasing or developing the software in order to increase efficiencies, maintain competitive advantage, or directly generate cash inflows over the useful life of the software. This qualifies the expenditure for treatment as an asset. We believe the greatest benefit received through asset treatment is the matching of expenses to the periods when related income is earned. This benefit will exceed the cost to report the software as an asset. The cost of reporting would include; collection of relevant data such as payroll expenses, recording those expenses as the original cost on a fixed asset system, monitoring the amortization over the life of the asset, maintaining review of the asset for possible impairment or required enhancements, and performing proofs to ensure all the information is interfaced into the general ledger.

Question Two is related to the amortization of the asset. The Company believes that the Accounting Standards Executive Committee (AcSec) is correct in not specifying a maximum life or a certain method of amortization. Software assets that are developed for internal use may be unique to the developer. The company that develops it and places it into service is best qualified to determine the life of the asset. In addition, Generally Accepted Accounting Principles currently allow different methods of amortization which enables an entity to select the one that best fits its asset types, management goals, and industry standards. To require a specific type of amortization would eliminate this benefit.

Question Three deals with the accounting for impairment of the software asset. The Company agrees with the AcSec that impairment should be handled according to Statement of Financial Accounting Standards (SFAS) No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* SFAS No. 121 states that an asset be measured for impairment when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The SOP concludes that, "when it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of carrying amount or fair value, if any, less costs to sell in accordance with FASB Statement No. 121." This guidance is sufficient for entities to recognize and measure impairment.

Question Four asks if an entity should be required to meet technological feasibility criteria similar to that established in SFAS No. 86, *Accounting for the Cost of Computer Software to be Sold, Leased or Otherwise Marketed,* before it begins capitalizing costs. This would require that an entity complete all planning, design, coding, and testing necessary to establish that the software can be produced to meet its design specifications. Only then would capitalization begin. We agree with the AcSec conclusion that a technological feasibility requirement should not be applied before internal-use software development costs be capitalized. We agree that the costs of internal-use software should be capitalized based on principles similar to those for long-lived assets.

Question Five asks if the SOP is too broad or narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. The SOP lists capitalizable expenses that include:

- External direct costs of materials and services consumed in development or obtaining internal-use software.
- Payroll and payroll-related costs for those directly associated with the project.
- Interest costs incurred while developing internal-use computer software.

We feel that specific mention is required to include the cost of installation of the software. The SOP is vague on this point and needs to clarify treatment of this expense which would be included in most if not all such projects.

Question Six deals with whether the SOP provides sufficient guidance to help entities determine whether computer software is for internal use. The SOP is somewhat broad in this area as it lists only two general requirements to classify the asset as internal-use software:

- The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- During the software's development or modification, no plan exists to market the software externally.

We believe the above guidance gives entities the proper amount of latitude to make correct decisions as it applies to their specific situations.

Question Seven asks if the SOP is correct in requiring SFAS No. 86 treatment for software that is developed for both internal-use and external marketing. Should entities be allowed to separate the internal-use portion and capitalize it per the SOP? We agree with the AcSec's conclusions that it would be impractical to allocate costs between internal-use software and software to be marketed. The SOP provides sufficient flexibility by allowing companies to subsequently market internal-use software in an effort to recover costs. In the absence of a previously conceived marketing plan, such action would not preclude treatment as internal-use software per this SOP.

Question Eight asks if the guidance provided to distinguish between enhancements (capitalized) and maintenance (expensed) is workable. The AcSec defines enhancements as "improvements to existing internal-use software that extend the life or increase the utility (that is, additional functionality) of the software." Maintenance is defined as "activities undertaken after the software is ready for its intended use to correct errors or keep the software updated with current information." We believe the above language provides sufficient guidance for management to make the proper determination of whether expenses are enhancements or maintenance.

We would like to address one additional point. The SOP indicates that training expense, whether from in-house resources or included in the cost of purchased software, should be expensed as incurred. We feel that training is an initial cost required to make the software operational.

Similar to installation expense, it should be capitalized as part of the total asset. Any subsequent training of new users of the software would be expensed as incurred.

Summit Bancorp appreciates the opportunity to comment on this proposal. Should there be any questions about our comments, I can be reached at (609) 987-3220 or call Georgiann Bird at (609) 987-3572.

Very truly yours,

William J. Healy

William J. Healy

CHASE

The Chase Manhattan Corporation
270 Park Avenue - 28th Floor
New York, New York 10017-2070
212/270-7559

Joseph L. Sclafani
Executive Vice President
and Controller

April 17, 1997

Mr. David Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: File Reference No. 4262: Exposure Draft of Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

Dear Mr. Noll:

The Chase Manhattan Corporation (Chase) appreciates the opportunity to respond to the Accounting Standards Executive Committee's (AcSEC) Exposure Draft of a Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (the proposed SOP).

Although we commend AcSEC for its efforts to address the lack of consistency in the area of accounting for the costs of computer software developed or obtained for internal use, we strongly disagree with the conclusions in the proposed SOP to capitalize such costs in accordance with specified guidelines. As discussed in more detail under Issue No. 1 in the attached Appendix, such costs should be expensed as incurred for reasons relating to technological feasibility and the reliability of useful life assessments. The attached Appendix also provides Chase's responses to Issue Nos. 2 through 8 of the proposed SOP in the event that capitalization treatment is adopted.

We would be pleased to discuss our comments with you at your convenience. If you have any questions, please do not hesitate to contact me at (212) 270-7559 or David M. Morris at (212) 552-8207.

Very truly yours,

Issue No. 1: **Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting? (Paragraphs 19-25 and 50-67)**

Chase's accounting policy is to <u>expense</u> as incurred the costs of computer software developed internally or purchased for internal use. We believe that such expenditures do <u>not</u> create assets, such as fixed assets, that have ongoing value that can be readily measured and accounted for. Due to the inherent softness of software assets as discussed below, we expense the cost of all such assets.

- *Technological feasibility* - In recent years, the technically complex nature of software development projects has significantly increased the uncertainty of their successful completion. Additionally, the technological feasibility of such projects often is not reached until very late in the development process. As such, entities may have to record significant write-downs of capitalized software costs prior to the completion of software development projects as a result of unsuccessful efforts or technologies that suddenly become obsolete due to the introduction of more-advanced technologies. Accordingly, an entity should be required to meet technological feasibility criteria similar to those established in SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," before the entity begins capitalizing the costs of internal-use computer software. Since costs incurred subsequent to attaining technological feasibility often would be immaterial and it is sometimes difficult to determine when technological feasibility has been attained, we believe that all costs of internal-use computer software should be <u>expensed</u> as incurred.

- *Reliability of useful life assessments* - As discussed in paragraph 54 of the proposed SOP, paragraph 148 of FASB Concepts Statement No. 6, "Elements of Financial Statements," states that some "costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine." In today's rapidly changing technological environment, we question whether entities can make consistently valid assessments with respect to the appropriate lives over which to amortize the capitalized costs of internal-use computer software. This lack of reliable information could result in subsequent write-offs of such costs when software suddenly becomes obsolete due to the introduction of more advanced technologies and in misleading information for financial statement users as discussed in paragraph 55 of the proposed SOP.

For the reasons discussed above, the added costs of developing and maintaining a system for tracking, amortizing, and monitoring the potential impairment of the capitalized costs of internal-use computer software is not justified.

Entities should not have the option to capitalize or expense the costs of internal-use computer software because of the importance of comparability of financial information between entities, as discussed in paragraph 60 of the proposed SOP.

* * * * *

While we strongly recommend expensing the costs of internal-use computer software, we have provided comments with respect to Issue Nos. 2 through 8 below in the event that capitalization treatment is adopted.

* * * * *

Issue No. 2: **This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required? (Paragraphs 30-32 and 75)**

The conclusion not to specify a maximum amortization period or an amortization method is appropriate. These decisions should be left to the judgment of management, who should give careful consideration to the rapidly changing technology in software development. In view of the short lives of software in relation to many other assets, we also concur with the conclusion that amortization should begin when the computer software is ready for its intended use, regardless of whether the software has been placed in service.

Issue No. 3: **Should impairment of internal-use computer software assets be recognized and measured in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?" If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets? (Paragraphs 28-29 and 72-74)**

The provisions of SFAS No. 121 provide sufficient guidance for entities to recognize and measure impairment of internal-use computer software assets. We concur with the proposed SOP's rebuttable presumption that software being developed has a zero fair value when it is no longer probable that the software being developed will be completed and placed in service. However, this impairment issue would be alleviated significantly if an entity is required to meet technological feasibility criteria before it begins to capitalize qualifying software assets as discussed in our response to Issue Nos. 1 and 4.

Issue No. 4: **This proposed SOP requires capitalization of certain costs of computer software, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in SFAS No. 86, "Accounting for the Costs of Computer Software to Be**

Sold, Leased, or Otherwise Marketed") before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria? (Paragraphs 17-19 and 44-49)

For the reasons discussed in our response to Issue No. 1, an entity should be required to meet the technological feasibility criteria similar to those established in SFAS No. 86 before it may begin capitalizing the costs of computer software developed or obtained for internal use.

Issue No. 5: **Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded? (Paragraphs 26-27 and 68-69)**

We concur that external direct costs of materials and services consumed in developing or obtaining internal-use computer software should be capitalized. However, we consider the capitalization of payroll-related costs for employees and interest costs, as discussed in paragraph 26 of the proposed SOP, to be too broad. Such costs should <u>not</u> be capitalized for the following reasons:

- *Payroll and payroll-related costs* - The capitalization of such costs can be difficult to control and is potentially subject to abuse resulting in inappropriate payroll costs being capitalized and thus deferred. It also would require a significant administrative effort for those entities with numerous software development projects.

- *Interest costs* - Paragraph 46 of the Basis for Conclusions to SFAS 34, "Capitalization of Interest," states that:

    > Interest capitalization should be required only when the balance of the informational benefit and the cost of information is favorable. The Board judged that a favorable balance is most likely to be achieved where an asset is constructed or produced as a discrete project for which costs are separately accumulated and where the construction of the asset takes considerable time, entails substantial expenditures, and hence is likely to involve a significant amount of interest cost.

  With respect to the capitalization of interest related to the development computer software for internal use, there is considerable doubt as to whether there is a favorable balance of the informational benefit when compared to the cost of the information, especially if an entity is required to meet technological criteria before it may begin capitalizing interest as we recommended above under Issue Nos. 1 and 4.

We agree with the accounting guidance relating to the purchase of internal-use computer software from a third party when training and/or maintenance fees are not specified in the contract, namely to allocate costs among training, maintenance, and capitalized computer software costs, expense training costs as incurred, and expense maintenance fees over the maintenance period.

Issue No. 6: **Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why? (Paragraphs 4-15, Appendix, and Paragraphs 38-43)**

The guidance provided to help entities determine whether computer software is for internal use is sufficient and we agree that it is not practical to allocate costs between software to be marketed and software to be used internally.

Issue No. 7: **Software is sometimes developed or obtained for both internal and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in SFAS No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and SFAS No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or SFAS No. 86, but not both? If not, how should those costs be allocated? (Paragraphs 4-15 and 38-43)**

As indicated in our response to Issue No. 6, the approach in the proposed SOP that requires an entity to follow the guidance in either the proposed SOP or SFAS No. 86, but not both, is correct. We also strongly agree with the logical requirement under the proposed SOP to defer revenue recognition until all costs of the software have been recovered.

Issue No. 8: **The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational? (Paragraphs 24-25 and 63-64)**

We concur with the proposed SOP's guidance with respect to significant upgrades and enhancements versus maintenance activities because it is practical and consistent with the practices for other types of fixed assets.

Citicorp

399 Park Avenue
New York, NY
10043

Roger W. Trupin
Controller

April 16, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll,

Citicorp appreciates this opportunity to respond to the Accounting Standards Executive Committee's (AcSEC) Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use".

The speed and scope of technological change has dramatically accelerated in recent years, and technology expenditures have become (and will continue to be) increasingly significant for companies of all shapes and sizes. Technology is at the heart of many of the quality improvement initiatives embedded in business strategies, and it is important that the accounting treatment for the related costs not pose an inappropriate impediment to sound decision-making.

At the same time, we have to face up to the costs of these initiatives, and ensure that the accounting appropriately reflects these costs.

We accept the proposed SOP's view that a fixed asset model is appropriate for the costs of most purchased software intended for internal use, because the purchase transaction with an independent third-party helps to establish an initial value for the asset.

However, costs related to internally-developed software intended for internal use have more of the characteristics of an internally generated intangible asset than a fixed asset. There is never a "transaction" to crystallize the value of such an asset – instead, a series of what would otherwise be considered period costs are accumulated on the balance sheet over the development periods and then amortized to expense over the service periods.

We fully endorse the notion that current period expenditures for computer software may provide an economic benefit or efficiency in future periods. But this concept is not unique to computer software. Everyday, companies expend significant resources to:

- hire and train personnel
- research and develop new products
- build and maintain a brand name
- attract and retain customers
- establish and enhance operating policies and procedures
- measure and improve performance metrics.

Resources efficiently and effectively invested in these areas are likely to generate future values in excess of the current costs. In our view, expenditures for computer software are in many ways similar in nature to the items listed above. Yet the proposed SOP would create a significantly different accounting treatment for computer software by requiring capitalization rather than expensing these costs as incurred.

Capitalization of internally generated software is particularly troubling in view of today's rapidly changing technological environment, where organizations are continually required to spend for software upgrades and compensate for obsolescence. We also believe that the proposed impairment model is unworkable, because in the majority of cases there are no identifiable future cash flows attributable to computer software intended for internal use except at the highest level of organizational aggregation.

In our view, the issue of whether or not internally generated intangible assets should be capitalized is a major accounting issue that merits debate. There are some in the accounting profession who believe that the accounting model should be changed to permit these types of "soft" assets to be recognized on the balance sheet, while others do not. Financial statement users also have strong views on this matter.

We should <u>not</u> have a special rule for internally generated software costs without a more critical review of the bigger conceptual issues related to internally generated intangible assets. This is a broad issue that the SEC and FASB, rather than AcSEC, should address. As a result, we do not support the issuance of the proposed SOP.

Our responses to the questions specifically requested in the exposure draft are attached. I would be happy to discuss our comments with you at your convenience. Please feel free to call me at (212) 559-2867.

Sincerely,

Roger W Trupin

Attachment

Citicorp
Response to AICPA Proposed Statement of Position
Accounting of the Costs of Computer Software Developed or Obtained for Internal Use

1) *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

   No. The costs of computer software developed for internal use should be expensed as incurred. The only exception should be for off-the-shelf software purchased from third-party vendors, where the reporting entity does not bear the development risk associated with the software.

   The valuation characteristics of internal use software that is purchased is analogous to other fixed assets which are purchased at an arms length and recognized on the balance sheet at cost. However, the costs related to internally developed software have more of the characteristics of internally generated intangibles which are not currently recognized on the balance sheet.

   In our view, the accounting for costs associated with internally developed software should be consistent with the accounting for other types of internally generated intangible assets, which is generally to expense as incurred.

2) *This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

   No. To mitigate the spiraling pace at which technological change routinely occurs, we believe that the SOP should require that an accelerated amortization method (such as sum-of-the-years-digits) be utilized over a relatively short time period.

3) *Should impairment of internal use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

No. We believe that the use of the FASB Statement No. 121 impairment model is unworkable for software intended for internal use. In the majority of cases there will be no identifiable future cash flows that can be attributed to the software, except at the highest level of organizational aggregation.

4) *This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

Yes. The technological feasibility criteria established in FASB Statement No. 86 should also be required before capitalization of internal use software can commence. The theoretical basis for expense recognition of research and development costs for software that is marketed to others is the same for software that is used internally and should be given consistent accounting treatment.

5) *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

The proposed SOP has too broadly defined the types of computer software costs that may be capitalized, because it fails to distinguish software that is purchased from third-party vendors from software that is developed by (or on behalf of) the reporting entity. This is an important distinction, because purchased software can be reasonably accommodated by the fixed-asset model used in the SOP while internally developed software has more of the characteristics of an internally generated intangible asset. We believe that the scope of the SOP should be narrowed to permit capitalization only for software purchased from third-party vendors and to require that costs associated with internally developed software be expensed as incurred consistent with the accounting for other internally generated intangible assets.

However, if AcSEC ultimately requires capitalization of all internal use software, we believe the kinds of costs permitted should be narrowly defined. For these reasons, we agree with the SOP's exclusion of general and administrative and overhead costs from capitalization and feel that interest costs should also not be permitted to be capitalized.

6) *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is the guidance appropriate? Why?*

   Yes. The proposed SOP provides sufficient guidance to enable entities to determine whether computer software is for internal use.

7) *Software is sometimes developed or obtained for both internal and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

   Yes. We agree with the proposed SOP's approach. We do not believe that it is practical to allocate the costs of software projects between the portion that will be used for internal purposes and the portion that will be marketed to others. In our opinion, the accounting for software costs should be prescribed in either the proposed SOP or Statement No. 86, but not both.

8) *The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is this guidance operational?*

   No. The distinction between routine maintenance (expense) and enhanced functionality (capitalize) is increasingly difficult if not impossible to determine. In today's rapidly changing technological environment, organizations must continually upgrade software to run under newer enhanced operating systems and platforms, compensate for hardware and software obsolescence, or interface with newer more sophisticated programs. Each of these reasons for upgrade may provide the enhanced functionality necessary for capitalization under the proposed SOP. Further, routine maintenance and upgrades and enhancements which extend the life or increase the functionality are typically performed at the same time, making any allocation arbitrary.

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You're in good hands.

April 16, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
File Reference 4262
American Institute of Certified Public Accountants
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Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

The Allstate Corporation (Allstate) appreciates the opportunity to comment on the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants' proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (the proposed SOP). As Allstate develops and obtains computer software for internal use in its operations, we are very interested in the outcome of the proposed SOP.

Overall, we recognize and support the need for further accounting guidance on accounting for the costs of computer software developed or obtained for internal use with the objective of minimizing diversity in accounting practice and enhancing comparability of financial statements among all reporting entities. Accordingly, we support the issuance of the proposed SOP in final form if certain implementation items are clarified, as discussed in the following paragraphs.

Issue No. 4 discusses whether an entity should be required to meet the technological feasibility criteria of FASB Statement No. 86 before it may begin capitalizing the costs of computer software developed or obtained for internal use. We agree with Paragraph No. 45 of the proposed SOP's Basis for Conclusions that the criteria in FASB Statement No. 86 does not apply to internal-use software. However, additional guidance on when capitalization should begin may be beneficial to eliminate diversity in application of the proposed SOP. Specifically, expanded examples of what costs are included in the "preliminary project stage" of development will be helpful, and in our opinion, necessary to ensure that all entities consistently apply the provisions of the proposed SOP.

Issue No. 5 focuses on whether the scope of the proposed SOP is too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. We believe the scope of the proposed SOP is appropriate. We do, however, suggest that AcSEC provide additional guidance with respect to specific costs associated with reengineering operations that are excluded from the scope of this SOP in Paragraph 10. Specifically, it has been Allstate's experience that it is difficult to differentiate costs of reengineering operations from the costs to internally develop software, when these projects occur simultaneously utilizing shared resources. Therefore, to implement the provisions of the proposed SOP in these situations, additional guidance is necessary.

Thank you for your thoughtful consideration of this letter. Please feel free to contact me at (847) 402-2213 if you have any questions or if you would like to discuss our comments.

Sincerely,

Samuel H. Pilch

Samuel H. Pilch
Controller
The Allstate Corporation

cc: Mr. Thomas J. Wilson
Vice President and
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April 16, 1997

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File Reference 4262
Proposed Statement of Position–*Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

Dear Mr. Noll:

We are pleased to comment on the AICPA's Exposure Draft of a proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (the Exposure Draft). We support issuance of the Exposure Draft as a final Statement of Position (SOP) but believe that AcSEC should further define an internal use software project and clarify certain other aspects of the Exposure Draft. These recommendations and our other comments are discussed below and in the Appendix to this letter.

Definition of a Project

Paragraph 20 of the Exposure Draft states that capitalization should occur when:

> Management, with the relevant authority, authorizes and commits to funding a computer software project and believes that it is probable that the project will be completed and the software will be used to perform the function intended.
>
> Conceptual formulation, design, and testing of possible software project alternatives (the preliminary project stage) have been completed.

The term "computer software project" is not defined in the Exposure Draft. As a result, the guidance describing when capitalization of internally developed software should begin may be interpreted broadly to require capitalization of costs associated with reengineering of existing processes when those activities are integral to the completion of the software project.

The final SOP should define the term computer software project and should include in the Basis for Conclusions a discussion as to why reengineering activities are not within the scope of a computer software project and, accordingly, why the costs of those activities should be charged to expense as incurred.

Enhancements

Upgrades and enhancements to internal-use software are discussed in paragraph 24 and in paragraphs 63 and 64 of the Basis for Conclusions. Although significant upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures will result in significant additional functionality or a significant extension of the software's useful life, certain significant upgrades or enhancements may obsolete portions of the existing code. Any unamortized costs associated with the obsolete code should be written off. The Exposure Draft indirectly addresses this issue by stating in paragraph 28 that an example of impairment may include a significant change to the software program. The final SOP should explicitly state that a modification or enhancement that improves the functionality of the software, or extends its useful life, also may impair a portion of the software and requires a writedown of the carrying amount of previously capitalized costs.

Software Vendors

AcSEC should clarify the intent of paragraph 13. Is it intended to require entities that market computer software to account for all development of software under Statement of Financial Accounting Standard No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,* (SFAS 86), even if the software is intended solely for internal use and the entity has no history of both using and marketing software? Or, is it intended to require entities to apply SFAS 86 only if the entity has a history of both using the software internally and marketing it to others? We believe SFAS 86 should be applied only when there is a history of both using and marketing the software.

Other Clarifications

Paragraph 16 identifies an implementation stage as the last stage of computer software development but provides little description of the activities in that stage. The final SOP should more clearly define those activities and provide further guidance as to how to determine that this last stage is complete and capitalization of costs should cease.

Paragraph 17 of the Exposure Draft distinguishes between purchased or leased software and internally developed software. The final SOP should clarify whether software developed by outside parties under the supervision of the entity that will use the software should be considered purchased software or internally developed software. This distinction is important in determining whether the costs of the software should be capitalized if the software has an alternative future use.

* * * * *

If you have any questions regarding our response, please contact Naomi Erickson at (203) 761-3138 or John Smith at (203) 761-3199.

Yours truly,

Deloitte & Touche LLP

APPENDIX

DELOITTE & TOUCHE LLP COMMENTS
PROPOSED STATEMENT OF POSITION
ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

The following are responses to the specific requests for comment in the transmittal letter included in the Exposure Draft.

Issue 1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

The costs of software developed or obtained for internal use should be capitalized provided they are not research and development costs as defined by FASB Statement No. 2, *Accounting for Research and Development Costs*, and the software qualifies as an asset. Entities should not have the option to expense or capitalize those costs, since that would perpetuate the current diversity in practice.

The costs to prepare and report the required information and the benefits of that information are best addressed by the preparers and users of financial statement information.

Issue 2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why and what methods should be required?

The SOP should not specify a maximum period for amortization. Each entity should assess the useful life of its internal-use software based on the criteria established in paragraphs 30 - 32 of the Exposure Draft. Entities with the same internal-use software could come to different conclusions on the appropriate life for their software based on their respective intentions and judgments.

Similarly, the SOP should not require specific amortization methods; preparer should be permitted to select an amortization method that allocates the cost in a systematic and rational manner to the periods the related assets are expected to provide benefits. This would be similar to the treatment of depreciation and amortization for other types of fixed assets.

Issue 3: Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121,* Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

We agree that entities should make an assessment of impairment based on the provisions described in SFAS 121 and believe that the guidance in this proposed SOP is sufficient.

Issue 4: This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86,* Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed) *before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

The technological feasibility criteria in SFAS 86 should not be incorporated into this SOP. Those criteria have not worked well in practice for software that is marketed and have, in fact, resulted in a perception that SFAS 86 provides a choice as to whether costs should be capitalized or charged to expense. A recent survey by Deloitte & Touche LLP, *Research and Development Survey of Software Companies* (a copy of which is enclosed), indicates a trend toward expensing all costs to develop software to be marketed to third parties.

Issue 5: Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

As discussed in our letter in the section titled "Definition of a Project," the final SOP should define an internally developed software project and provide the guidance on the types and timing of capitalized expenditures should be expanded.

Issue 6: Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

The guidance set forth in paragraphs 38-43, together with the Appendix to the Exposure Draft, is sufficient.

Issue 7: Software is sometimes developed or obtained for both internal and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software

in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

We agree with the guidance in the Exposure Draft. An allocation approach would add complexity and the amounts allocated would likely be arbitrary and subject to wide variability.

Issue 8: The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Additional guidance, including examples to illustrate "significant" and "additional functionality," is needed.

* * * * *

Fidelity Investments®

Gerald M Lieberman
Senior Vice President
Chief Financial Officer

FMR Corp.
82 Devonshire Street
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617 563 7620

April 16, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards, File 4262
AICPA, 1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Noll,

As the Chief Financial Officer of FMR Corp., the parent company of Fidelity Investments I am responding to AcSec's Exposure Draft of Proposed Statement of Financial Position entitled "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". Fidelity Investments is extremely concerned with the proposed SOP. A privately held company, FMR has total revenues in excess of $5 billion a year and total assets in excess of $18 billion. Our technology spend on an annual basis is substantial. A significant portion of our annual operating budget is used to develop and maintain state of the art financial, operating, management information and telecommunication systems. In addition to our views concerning the impact of potential changes in accounting for software on our own financial statements, we are also concerned from the prespective of a signigicant user of other companies' financial statements. We are the largest mutual fund manager in the country with approximately $500 billion of assets under our management. Our investment management professionals regularly follow approximately 5000 companies and rely heavily on financial statement information as part of their regular analysis process. Therefore, the proposed SOP will have a major impact on Fidelity.

From both of these perspectives we are convinced that consistency and comparability, two fundamental underpinnings of financial reporting, cannot be achieved by capitalization and deferral of internally developed internal use software. The ability to develop software efficiently varies from entity to entity, application by application and is impacted by a myriad of factors both tangible and intangible. The criteria being proposed for capitalization of costs are in themselves very subjective and are insufficient to control the amount of costs which potentially can be capitalized as part of a project. Although there may be evidence of future value associated with discrete projects to internally develop software (because most entities require some type of cost benefit analysis as justification for resource allocation), we question whether such value can be reasonably and objectively determined in such a manner as to assure consistency and comparability. We believe this issue is critical to the evaluation of financial trends and comparisons of competing entities which is basic to the accounting and analysis processes.

We recognize that FAS #121 applies to externally produced software purchased by a company. However, such software has an objectively determined value -- the price charged in the marketplace through transactions between unrelated parties. By contrast, there is no objective indicator of value for internally produced software. Indeed, companies develop their own software precisely when the marketplace does not provide any product with the necessary features, or when the only external software available requires extensive modifications to meet the company's needs. In such cases, the company has no objective method of evaluating internal software as an asset for balance sheet purposes.

Furthermore, as one of the largest investors in publicly reporting companies, we are extremely concerned with the direction this proposal takes and the dangerous precedent which we believe is being established whereby what we consider as "soft assets" will be placed on the balance sheet. We believe the SOP will result in capitalization policies which distort current earnings trends and comparisons, will add to earnings volatility and will overstate the real net worth of an entity. As a result, we believe this proposal will adversely impact the ability of users of financial statements, including analysts and portfolio managers charged with the responsibility for billions of dollars of assets under their direction, to make informed investment decisions.

In conclusion, Fidelity Investments believes that current generally accepted accounting practice under which software externally obtained for internal use is capitalized and internally developed software for internal use is expensed, are the only practices which can promote comparability and consistency in financial reporting.

Our specific objections are outlined in the Appendix to this letter. We would welcome further opportunities to discuss our views with the Committee.

Sincerely,

Gerald M. Lieberman
Senior Vice President and
Chief Financial Officer
FMR Corp.

APPENDIX

SPECIFIC OBJECTIONS TO THE PROPOSED STATEMENT OF POSITION

1. ***No Distinction Is Made Between Internally Developed And Externally Purchased Software***

   We believe that the Committee must address internal use software which is developed internally versus that which is purchased externally in a very different manner. Software products which are purchased externally typically are established products with proven feasibility and functionality. While externally purchased products are frequently modified to meet specific company needs, the basic functionality exists and has been assigned a value by the market place in transactions between unrelated parties. Entities turn to internal development when specific functionality required does not exist in the market place or would require such significant modification that the decision to purchase cannot be cost justified. We believe the existing proposal does not make an adequate distinction between the two.

2. ***Preliminary Project Stage Concept Provides Inadequate Criteria For Capitalization***

   We believe that Preliminary Project Stage as defined in the Exposure Draft does not provide sufficient guidelines to assure that there will be any consistency surrounding the point at which capitalization can commence. Furthermore, the criteria as required by the "Preliminary Project Stage" are insufficient to assure that a viable project is being undertaken. We do not believe that the very rudimentary steps of allocating resources, defining requirements and exploring alternatives are sufficient to allow the capitalization of costs to commence. At a minimum, some feasibility test must be required. There is no question that the proposed rules will result in capitalization commencing sooner than if some technological feasibility test is required. Additionally, development costs which would be expensed by a marketer of software would be capitalized by the internal use developer. Finally, we believe that the subjectivity allowed by the Preliminary Stage Criteria will result in accounting abuses from entities seeking to maximize short-term earnings objectives.

3. ***The Proposal Minimizes The Question of An Entity's Ability To Efficiently Plan, Design And Develop Software Products And Attempts To Address The Issue Via The Concept Of Impairment Under FAS #121***

   The proposed principles do little to assure comparability among entities and in fact we believe reward those entities that are less efficient in software development by allowing the cost to be capitalized and amortized over several years. The cost of software development varies significantly from company to company and is impacted by such factors as platforms on which the software will operate, the sophistication of the company's end-users, the functionality required by the end-users as well as the entity's ability to efficiently develop software. Software developed to provide similar service or end-use may have widely varying costs incurred in the development. Furthermore, we believe that the Committee's attempt to address the efficiency or "excessive cost" issue via the Impairment rules of FAS #121 is inadequate.

The ability to efficiently develop software is a fundamental issue, not one to be addressed after the fact via "Impairment" principles. To address this question via a discussion of impairment is an acknowledgment that inefficiencies will occur and related costs will be capitalized and deferred. Furthermore, this issue is made even more subjective by referring to costs that "significantly" exceed the amount "originally expected". What guidance exists to evaluate "originally expected" vs. costs associated with subsequent changes? When do cost overruns become "significant"?

4. ***Applying the FAS #121 Impairment Concepts Will Result In Inappropriate Asset Valuations***

Since most software products developed for internal use will not have a specific identifiable cash flow expected to result from their use, impairment (or a limit on the amount capitalizable) will often be measured with reference to expected future cash flows of an asset group, product group, or division or even at the entity level. We do not believe FAS #121 was intended to address asset impairment in this manner and its application to internally developed software will assure that costs associated with inefficiencies or changes which do not add significantly to the value of the asset will be capitalized.

5. ***Concern That The Committee Is Responding To A Perceived "Predominant Practice" Without Recognition Of The Quality Of Assets***

We are concerned that the Committee is responding to a perceived "predominant practice" which has evolved. The Committee acknowledges that at the time of FAS #86 issuance that the majority of all firms expensed costs of developing software for internal use and this practice was not considered improper. FAS #86 has been in effect for more than ten years and has required relatively little interpretation by either the FASB or the EITF. Our understanding is that FAS #86 did not lead many companies to consider capitalizing software developed for internal use and that, in fact, very few companies now capitalize those costs. Therefore, we have concluded that a pronouncement that would prohibit capitalizing software developed for internal use would result in fewer accounting changes than the proposed SOP.

6. ***The Proposed SOP Is Inconsistent With Other Existing And Proposed AcSec Pronouncements On Deferred Costs.***

Several years ago, AcSec issued SOP 93-7 on advertising costs, which sharply limits the types of costs, and criteria under which costs associated with direct response advertising may be deferred. More recently, AcSec is in the process of issuing a proposed SOP on start-up costs, which will, if approved, prohibit the deferral of start-up costs, including pre-opening costs, We concur with both these positions, including our understanding of the proposed SOP on start-up costs, but we have concluded that software for internal use should be subject to some of the same criteria that are expressed in these other pronouncements. For example, SOP 93-7 limits the types of costs which may be deferred and limits the deferral methodology and amortization to only those costs where a direct benefit (such a positive customer response) can be measured. Although we have not yet seen the published exposure draft on start-up costs, we understand that one of the key reasons for prohibiting the deferral of start-up-costs was the difficulty in measuring economic benefit created by the incurrence of start-up costs. We submit that software developed for internal use has exactly the same types of measurement uncertainties as start-up costs.

John Hancock Mutual Life Insurance Company

Controller's Department

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Janet A. Pendleton
Vice President and Controller

John Hancock
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April 14, 1997

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Exposure Draft: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

The John Hancock Mutual Life Insurance Company supports, in general, the AICPA's efforts to address the inconsistencies in the present accounting literature regarding computer software developed for internal use. Overall, we believe such costs should be capitalized and we agree that the proposal will reduce the reporting diversities that are now present in the treatment of internal use computer software costs.

While we are in general agreement with the proposed SOP, we do not necessarily share the AICPA's opinion in the proposed guidance that companies could not continue to elect to use the conservative policy of expensing internal use computer software costs. We believe that if they disclose this election in their footnotes to the financial statements, the overall diversity objectives of the SOP would not be materially compromised.

Additionally, we would also like to see the SOP contain various examples of what costs would be included or not included in certain provisions of the proposed guidance. For example, we would find it helpful if the guidance had representative examples of what upgrades and enhancements could be capitalized versus those that had to be expensed. Such examples would provide a clearer picture of the AICPA's intent regarding these classifications, and therefore companies could apply the guidance more consistently in their financial statements. These examples could be added as an appendix to the SOP guidance.

We appreciate the opportunity to express our comments on this exposure draft. If you have any questions or need additional information, please contact me.

Very truly yours,

Janet A. Pendleton

Janet A. Pendleton
Vice President & Controller

CATERPILLAR®

Caterpillar Inc.

100 NE Adams Street
Peoria, Illinois 61629

April 11, 1997

Daniel Noll, Technical Manager
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Accounting Standards File 4262

Dear Mr. Noll:

Caterpillar appreciates the opportunity to comment on the proposed Statement of Position (SOP), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Many companies derive a significant amount of economic benefits every day from internal-use, computer software. We support the AcSEC initiative to develop authoritative guidance to help minimize the inconsistencies that currently exist when accounting for the costs of computer software for internal-use. Our concern with this proposed SOP is that it does not require that an entity meet technological feasibility criteria before it begins capitalizing qualifying costs. We strongly believe that this SOP's guidance regarding activities categorized as research and development (R&D) costs contradicts current authoritative guidance from the Financial Accounting Standards Board. Additionally, it conflicts with the Internal Revenue Service rules which allow our company to receive R&D Tax Credits for activities not recognized by this SOP as R&D costs. Before issuing a final standard, we urge the AcSEC to modify this SOP to state that costs associated with software development activities up to the point of technological feasibility are to be accounted for as R&D costs.

We believe that this proposed SOP contradicts Statement of Financial Accounting Standards No. 2 (FAS 2), "Accounting for Research and Development Costs" and Statement of Financial Accounting Standards No. 86 (FAS 86), "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed." FAS 86 specifies that costs incurred in creating a computer software product shall be charged as R&D costs until technological feasibility has been established for the product. The AcSEC contention is that the technological feasibility criteria applied in FAS 86 are appropriate to an "inventory model" only. Whereas, internal-use software should be capitalized and based on principles similar to those for long-lived assets. We do not agree with this "fine line" that the AcSEC is drawing in the sand. We believe that this is a very narrow interpretation of FAS 2. Paragraph 8 of FAS 2 defines development as "the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use." Paragraphs 8 and 9 give several examples of what should and should not be included in R&D. The AcSEC is attempting to categorize some of these examples into either an "inventory model" or a "long-lived asset model," and then say that each model has different criteria for what constitutes R&D.

FAS 2 gives broad definitions for "research" and "development." We believe that to correctly interpret FAS 2 you must look at these definitions and the several examples as a whole. Our interpretation of FAS 2 is that the FASB intended for entities to include in R&D costs those activities that get a product or process to technological feasibility. Why else would there be R&D examples that include the construction of prototypes, the operation of pilot plants, and engineering activities to the point of ready for manufacture? Why are there no examples of costs associated with getting a product or process to technological feasibility that are considered to be **excluded** from R&D? Additionally, nowhere in FAS 2 does the Financial Accounting Standards Board try to distinguish different rules for inventory items versus long-lived asset items. We believe that it would be wrong to try and make this distinction.

In summary, we generally agree with the guidance being provided by this SOP except for the concerns we expressed above regarding R&D costs. We strongly urge the AcSEC to revise its guidance regarding R&D costs before issuing a final SOP.

We appreciate the opportunity to express our concerns.

RRGallagher

R.R. Gallagher
Corporate Controller

THE WILLIAMS COMPANIES, INC.
ONE WILLIAMS CENTER — TULSA, OKLAHOMA 74172

GARY R. BELITZ
CONTROLLER AND CHIEF ACCOUNTING OFFICER
(918) 588-2832

April 14, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The Williams Companies, Inc. is pleased to submit the following comments in regard to the Exposure Draft on "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." We agree that certain costs of internal use computer software should be recognized as an asset and we generally agree with the other provisions in the Exposure Draft.

However, we believe that the criteria for when capitalization of costs should begin, as proposed in paragraph 20, needs to be revised to more realistically reflect the current environment for software development. Paragraph 20 should be revised to provide for capitalization of costs incurred for the design, coding and testing of the chosen path, as long as it is probable that the project will be completed and the software will be used for its intended function. The requirement in paragraph 20 to begin capitalization of costs once management approval occurs and conceptual formulation, design and testing of alternatives have been completed should be removed. Our approach recognizes that a "bright line" cannot be drawn between the preliminary project stage and program instruction stage as a basis for capitalization of costs. Based upon discussions with our computer software development experts, we believe that current software development methodologies and tools result in the design and coding activities occurring earlier in the development process than appears to be recognized in the Exposure Draft. The current proposal in paragraph 20 could result in significant design and coding costs and development effort not being capitalized. We believe our approach will provide the flexibility required to recognize the capabilities of current software development methodologies and tools, while appropriately capitalizing the costs of design, coding and testing.

We appreciate the opportunity to comment and would be pleased to discuss our views with AcSEC and the AICPA staff.

Sincerely,

Gary R. Belitz

Gary R. Belitz
Controller and Chief Accounting Officer

GRB/vlp

H:\ACT\BMNOLL.LTR

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MICHAEL R. AYERS
Vice President
and Controller

April 17, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA, 1211 Avenue of the Americas, New York, NY
10036-8775

Subject: Accounting for the costs of computer software developed or obtained for Internal use.

Dear Mr. Noll:

We appreciate this opportunity to comment on this exposure draft. It is our recommendation that the exposure draft be modified to capitalize only significant internal use software projects, and to mandate the use of one amortization method and useful life. Support for our suggestions are as follows:

Paragraphs 3 and 60 of the exposure draft state that the main reason for the draft is to enhance comparability among entities. We agree that comparability is a worthwhile goal; however, with all of the various useful lives applied to fixed assets, and no guidance on useful lives provided with this exposure draft, we believe the current draft would do very little to improve comparability between enterprises. We find it interesting that the exposure draft makes a blanket requirement that all internally developed or purchased software be capitalized, yet there is no mandate for useful lives and amortization method. In our opinion, one without the other will accomplish very little. Without guidance on useful lives, comparability between entities is compromised. Some companies will use very short useful lives, while others will use much longer lives, with the end result being little improvement in comparability between companies.

In addition, differing depreciation/amortization methods produce varying impacts on expense, income, and balance sheet accounts. Comparability is further compromised by divergent depreciation methods.

We understand the need for companies to evaluate their own situation and make their own business decisions, however, we feel that flexibility and comparability are opposing goals. It is impossible to attain both. If comparability among companies is truly the goal, then flexibility in interpreting and applying useful lives or amortization methods is self-defeating.

We also feel that the guidance received on upgrades and enhancements in paragraph 24 is subjective and could be applied broadly among different companies. Software manufacturers could argue that each upgrade meets the requirements of "additional functionality", established in paragraphs 24 and 63. Undoubtedly that is why the upgrade was released. Most upgrades qualify for the definition in paragraph 64 that enhancements are "improvements to an existing product that are intended to extend the life or improve significantly the marketability of the original product". Again, we feel that with the subjectivity in the guidance received, comparability among entities will be compromised.

Internal use software by its very nature has little, if any use to other entities. Most purchased software is adapted and changed to meet the requirements of the individual company, thus losing resale value to others. Theoretically, the NBV of an asset is its fair market value. Internal use software fitting the needs of a specific company would have no market value. General software has a short shelf life in the marketplace. Software tailored to specific company needs has no market value.

We believe that capitalizing software costs is not "conservative" accounting. With software changing so rapidly, these costs have questionable value as long-lived assets. As mentioned in paragraph 28 there are several events that could occur which would require a FASB 121 impairment write-off. We don't believe that FASB 121 was meant to be applied to software as a single asset. We understand FASB 121 to be applied to a group of revenue producing assets as a process that generated cash flows. However, we believe that software has questionable value as an asset under the "Lower of cost or market" principle for estimating asset values. "Lower of cost or market" theory suggests internally developed software be written off immediately, since it has no market value. Carrying unique, internally developed software, or software that has been substantially tailored to a specific business as an asset tends to overstate the value of balance sheet assets.

Paragraph 67 of the exposure draft states that the "users of financial information will find the results of this exposure draft useful", while paragraph 34 states that there are no new disclosure requirements. So, in most cases, the new capitalization requirements for internal use software would not be material enough to warrant the creation of a new line item on the balance sheet or in the notes to financial statements. Thus, capitalized internal use software would be added to "Machinery and Equipment" on the balance sheet, eliminating any possible gain in the amount of information disclosed to the reader of financial statements. Contrary to paragraph 67, we know as users of financial statements that it is very difficult to glean information from the PP&E section of a company's balance sheet. This difficulty is due to all the available options of useful lives and depreciation methods, as well as the predominant grouping of fixed assets into one of three categories.

It is our opinion that if the Accounting Standards Executive Committee (AcSEC) is intent on capitalizing internal use software, they may be better served to raise the threshold. Instead of capitalizing all internal use software, capitalize only the significant projects, such as a new payroll system, or general accounting ledger systems. This would eliminate the subjectivity of upgrades, and fast changing PC-based software. Tiers or levels of materiality could be set up depending upon the size of a company.

For example, the following capitalization schedule may be used:

Companies with Sales less than	Capitalize software costs over

$ 50 million	$ 50,000
100 million	100,000
500 million	500,000
Greater than 1 billion	$1,000,000

Then if AcSEC is truly concerned about comparability, there should be a mandate that all capitalized software be amortized under a single useful life, such as four years or less. One amortization method, which depreciates heavily in the first few years such as double declining balance, should be mandated as well. This would tend to more fairly represent the balance sheet given the short life of computer software. A system like this would eliminate subjectivity, and increase comparability. This system would also be more cost effective, making the exposure draft cheaper and easier to implement.

In summary, we feel that to implement the exposure draft as written, for the sake of comparability is misleading, given that there is no guidance on useful lives, or amortization methods. Capitalizing internal use software, which has virtually no resale value and questionable future value is not "conservative" accounting. With no new disclosure requirements, the ultimate benefit to the end user is negligible, since capitalized internal use software will be combined with "Machinery and Equipment" for reporting purposes.

Capitalizing only significant projects and mandating a common useful life and amortization method would eliminate problems with comparability, as well as be conservative, and would be simple and cost effective to implement.

Thank you for this opportunity to comment on this exposure draft, we hope you will find our suggestions helpful in your issuance of the final standards.

Sincerely,

Michael R. Ayers

MRA/grs

American Express Company
American Express Tower
World Financial Center
New York, New York 10285

April 17, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262: *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

American Express Company appreciates the opportunity to express its views on the Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (PSOP).

We support this effort to reduce the wide disparity in accounting practice. In addition, we conceptually understand that the cost of internal use software meets the definition of an asset - internal use software is similar to any other capitalizable tool that is directly or indirectly used in the production of income.

However, software applications make poor candidates for reliable presentation on the balance sheet. Specifically, technical obsolescence rapidly decreases the economic value of software. Further, software cannot be retooled in the same way as tangible assets, and it generally has no residual value. Thus, we are of the same view expressed by some (as noted in the PSOP's basis for conclusions) that users of financial statements can be misled by the initial capitalization and subsequent write-off of software costs.

Therefore we recommend that the conclusion that technological feasibility (TF) does not apply to the PSOP be revisited. The degree of unreliability imbedded in the capitalization of software on the balance sheet compels the inclusion of TF into this accounting model. We understand the PSOP's objective of minimizing the inconsistencies that currently exist in practice but for the reasons described above we do not support the conclusions of the PSOP. We recommend that software costs be expensed as incurred.

As a practical note, if the PSOP were finalized as now proposed, its effective date should be at least one year after the date of issuance to allow time for entities to develop internal procedures and systems to implement the requirements. At any point in time American Express has several hundred projects in process. Our present systems and procedures for tracking software development costs would require substantial reworking to result in a cost accounting process that could produce reliable and auditable balance sheet data.

We would be pleased to further discuss our comments with you should you have any questions or comments. Any questions may be addressed to me (212-640-5478) or to Jay Perrell (212-640-3658).

Yours truly,

Daniel T Henry

Daniel T. Henry
Senior Vice President
and Comptroller

Aerospace
Industries
Association

LeRoy J. Haugh
Vice President
Procurement and Finance
(202) 371 8520

April 17, 1997

Mr. Dan Noll
Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, New York
10036-8775

REF: Exposure Draft on "Accounting For the Costs of Computer Software Developed or Obtained For Internal Use"

Dear Mr. Noll:

The Aerospace Industries Association (AIA) appreciates the opportunity to respond to your exposure draft on "Accounting for the costs of computer software developed or obtained for internal use." AIA is a nonprofit trade association representing the nation's manufacturers of commercial, military, and business aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment.

Mandatory Capitalization Unnecessary

The exposure draft is placing "Form over Substance" rather than "Substance over Form." The AcSEC's reliance on FASB Concept Statement No. 2 (which states, "Comparability between enterprises and consistency in the application of methods over time increase the informational value of comparisons ...") as the basis for the mandatory capitalization of internal use software is misplaced for a variety of reasons. Additionally, without a prescription for the use of common methods and periods for amortization, any "comparability" gained by requiring capitalization will be self-defeating.

These costs do not need to be capitalized for the marketplace to determine the technological capabilities of entities when it establishes market values. The marketplace will establish values based on technological reputation and other factors, notwithstanding the values placed on internal use software in the balance sheets of companies operating in the marketplace.

Other comparable costs have different accounting treatments. As an example, acquired patents are usually capitalized but the costs of developing patents are usually expensed as incurred. Why would internally developed software have any more future value than the development of a patent?

Also, an entity's own internal labor and related benefits for developing in house software should never be capitalized. This labor would have been period overhead costs if not for the software project. Since overhead costs identified with the aforementioned internal labor are specifically excluded from allocation and capitalization in this new guidance, it is neither reasonable nor consistent to capitalize these otherwise period labor and benefit costs.

Uncertain Economic Benefit

The capitalization of these costs in such a rapidly changing, fast paced environment is not "conservative" accounting. Nowhere is the future economic benefit more uncertain and the potential for technological obsolescence more rapid than in the computer field. Software and computing technology is such a rapidly changing field that most equipment and software items quickly become obsolete. The software development industry is highly competitive and fast moving companies have developed software to meet specific requirements because no software had been available in the marketplace. It is not unusual for new and improved software to become available before the current application can be fully implemented. Consequently, by the time some internally developed software could be tested and implemented, a similar product could be available for sale at a fraction of the costs incurred internally. Further, commercial off the shelf (COTS) software packages become obsolete quickly and need to be updated. Most importantly, the cost of COTS software is merely a license to use the coded intelligence and does not typically represent ownership of an asset.

FASB Concept Statement No. 6 indicates that one of the characteristics of an asset is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits. Internal use software does not necessarily provide net cash inflows. The AcSEC's justification for this shortcoming is to compare this "intangible" asset to "tangible" assets such as computer hardware or furniture, both of which have some true resale market value. However, these internal use software costs, by definition and intent, do not have any resale market value.

Capitalizing these software costs can be compared to capitalizing Goodwill before any independent third party was willing to pay for the market value. APB Opinion 17, paragraph 24 states that "costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole -- such as goodwill -- should be deducted from income when incurred."

Clearly, internal use software has questionable value as a long-lived asset and requiring capitalization would be inconsistent with the accounting concepts reflected in FASB 121. Since internal use software is either developed specifically for, or modified extensively to fit, a business entity's specific circumstances, unlike other "long-lived assets," it is not likely to have any measurable market value. Thus, if capitalized, software would continuously have to be evaluated to determine if an impairment loss occurred and, unless there was some certainty of future business prospects, an immediate write-off would be necessary. To require capitalization with a high probability of immediate write-off due to impairment does not seem logical.

It is also difficult to measure future benefits with reasonable certainty and assign a meaningful life to these "long-lived assets." Costs should be expensed if they cannot be allocated systematically and rationally, or if doing so would serve no useful purpose.

<u>Costs Outweigh Benefits</u>

There is no empirical proof offered by the AcSEC that the benefits of this accounting policy outweigh the cost. Rather, we believe that the expense to set up a job cost system in order to comply with the proposed exposure draft outweighs the benefits to be gained by this very limited consistency for consistency's sake.

Additionally, we believe that it is difficult to differentiate between upgrades or enhancements and maintenance and they should all have the same accounting treatment. Once a software module is in place, further upgrades and enhancements should be expensed. Most maintenance costs are merely responding to system deficiencies or on-going changes and improvements to the supported business processes. Upgrades and enhancements are usually the result of accumulated process improvements that cannot be handled through the normal maintenance process. Trying to differentiate between the two would be difficult, potentially costly and non-value added because the same activity is being done, often simultaneously; only the degree is different.

However, having considered all the reasons for not capitalizing these costs, we recognize the need for flexibility in this highly subjective area. Significant software costs may be appropriately capitalized in certain circumstances. For instance, when the cost of the internal use software is well above normal software changes and the improvements required to run normal operations, such as a new major operating system, the costs could be capitalized.

The amount of costs capitalized could be limited to that which would be spent on a viable software product from a third party. The idea of capitalizing all the false starts and mistakes of a software project with no limit as to the amount capitalized does not follow conservatism and, thus, good accounting practice. Additionally, this limitless capitalization concept is inconsistent with FASB 121 requirements.

Summary

The AIA does not believe that it is sound accounting practice to require mandatory capitalization of software costs for internal use and strongly opposes this dictate in all cases. Flexibility is needed as to when these costs should be expensed versus capitalized. Materiality and a determination of market value should be required before a long-lived asset is recognized.

We have attached brief specific answers to most of the eight areas of questions identified in the exposure draft notice.

AIA wishes to thank you for the opportunity to comment on this important subject.

Sincerely,

LeRoy J. Haugh

Attachment to Letter on "Accounting For the Costs of Computer Software Developed or Obtained For Internal Use"

1. **Capital asset versus expense**
   Comments regarding capitalizing versus expensing are covered in the body of letter responding to the exposure draft.

2. **Methods and periods of amortization**
   If software costs are significant and warrant capitalization, there should be a mandatory maximum useful life. This maximum should be short, four years or less, since the length of the future economic benefit is uncertain and technological obsolescence potentially rapid. The amortization methods used should not be mandated. If mandated, we would favor a method that weighed heavily on depreciation expense being more in the early years such as double declining balance.

3. **FASB Statement 121, Impairment**
   When these costs must be capitalized, impairment should be recognized in accordance with FASB Statement 121. Additional guidance in this proposed SOP is not required.

4. **Criteria in order to capitalize**
   As stated in the body of our letter, costs capitalized should be limited to costs that would be spent on a similar viable software product from a third party, i.e. estimated market value.

5. **Kinds of costs capitalized**
   As stated in the body of our letter, costs capitalized should exclude an entity's own internal labor and related benefits.

6. **Sufficient guidance**
   The SOP contains sufficient guidance.

7. **Software developed for internal use and external marketing.**
   We agree with the approach of the SOP in using FASB 86. However, if this exposure draft is modified to include a limitation as to the amount to be capitalized, then this limitation should be used for the costs of software developed for internal use and external marketing.

8. **Upgrades or enhancements versus maintenance.**
   As stated in the body of our letter, the difference between upgrades or enhancements and maintenance is usually indistinguishable and just a matter of degree. Consequently, such costs should be treated consistently and be expensed.

AICPA

April 8, 1997

Mr. G. Michael Crooch
Accounting Standards Executive Committee
Arthur Andersen, LLP
69 W. Washington Street
Chicago, IL 60602-3094

Dear Mr. Crooch,

The Professional Issues Subcommittee (the "PIC") of the Business & Industry Executive Committee appreciates very much the opportunity to comment to AcSEC regarding the AICPA's Exposure Draft of the Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Our comments on the issues raised in the Exposure Draft are summarized below.

Issue 1 - The consensus of our committee was that the costs of computer software developed or obtained for internal use should be recognized as assets. We did not feel that entities should have the option to either expense or capitalize, as this would likely lead to a lack of comparability in practice. It seems that the benefits of reporting such costs would outweigh the costs, provided that the final SOP provides some consideration that indirect costs should be accumulated and reported if practicable.

Issue 2 - We did not feel that the SOP should specify some maximum period of amortization for capitalized costs, although we did have some discussion that perhaps the final SOP should provide some type of "benchmark" amortization period (e.g. five years). As to method of amortization, the words "systematic and rational," as used in the Exposure Draft, appear to be adequate guidance and to also allow for professional judgment on the part of preparers.

Issue 3 - We feel that impairment of computer software assets should be accounted for in a manner similar to the accounting for impairment of other types of assets, as established in FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." It appears that Statement No. 121 provides sufficient guidance for this accounting.

Issue 4 - We did not feel that an entity should be required to meet specified technological feasibility criteria before capitalizing qualifying costs. Internally developed software implementations are generally not leading edge applications, and thus technological feasibility is likely. Paragraphs 18 through 25 appear to provide adequate guidance in this area. We did feel, however, that research and development costs should be segregated from software development costs and accounted for accordingly.

Issue 5 - While we feel that conceptually the proposed SOP is correct concerning what types of costs should be expenses and what types of costs should be capitalized, our committee discussed at some length the distinction between training costs and implementation costs. Our aggregate experiences suggest that in practice "training" and "implementation" are often undertaken simultaneously, with many of the same personnel involved in each endeavor. Perhaps some additional clarification of what constitutes training costs and at what point such training costs cease would be helpful to practitioners and would help to reduce controversy in practice.

Issue 6 - The SOP appears to provide sufficient guidance to help entities determine whether computer software is for internal use. We found the examples to be especially helpful.

Issue 7 - Our committee felt that the costs of trying to allocate costs between software intended for internal use and software intended to be sold would exceed any benefits to be derived from this treatment. In addition, absent any firm guidance in this area, allocations derived in practice would likely vary widely and would lead to a lack of comparability. We therefore feel that an entity should be required to determine which accounting treatment is more appropriate, this SOP or FASB Statement No. 86, and follow that appropriate treatment exclusively.

Issue 8 - We concur that the guidance in this SOP, which distinguishes between computer software costs that are upgrades or enhancements as opposed to maintenance costs, is operational.

Again, as representatives of the AICPA members in business and industry, we appreciate the opportunity to be a part of the standard setting process and to respond to this ED. If you have any questions, please contact Holly Nelson (612-726-7295) or Hadassah Baum (212-596-6019) of the AICPA staff.

Very truly yours,

Holly L Nelson

Holly L. Nelson
Chairperson
Professional Issues Subcommittee

Doug Mecimore cj

C. Douglas Mecimore, Jr.
Member
Professional Issues Subcommittee

cc: BIEC Members
PIC Members
Hadassah Baum

g

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April 17, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Subject: ***File No. 4262***

Dear Mr. Noll:

Following are our comments on the Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (the PSOP).

We generally support the PSOP's conclusions. Fundamentally, we have two concerns, both related to requirements to expense costs. Those concerns are addressed in our answer to Question 5, below. Following are our specific comments on the PSOP's questions.

Question 1 — Internal-Use Computer Software as an Asset

We support the PSOP's position. While we have not undertaken a formal study, our sense is that implementation costs are modest, and that benefits will exceed such costs.

Question 2 — Amortization

We agree with the PSOP's approach of not specifying a maximum amortization period, and we favor its definition of the point at which depreciation should commence.

Question 3 — Impairment

We agree with the PSOP's conclusion that impairment of capitalized software costs must be assessed in accordance with SFAS No. 121. AcSEC does not have the ability to specify an alternative to this accounting, and, although internal use software is one of several assets that will be extremely difficult to measure under this Statement, we believe its provisions must be followed.

Question 4 — Technological Feasibility

We strongly support developing an approach that does not rely on the SFAS No. 86 concept of technological feasibility. While our experience with SFAS No. 86 is limited, we understand that technological feasibility has created serious implementation issues. One of the primary improvements in financial reporting that will arise from the PSOP's approach is a further restriction of application of those impracticable rules.

Question 5 — Capitalizable Costs

We shall address two categories of costs — training costs and overhead.

The PSOP prohibits capitalization of training costs on the basis that these costs cannot be associated with specific future periods. We do not believe that the conclusion applies logically to all training. Rather, we believe there is a distinction among various types of training, a distinction that indicates that different accounting may be appropriate in different circumstances. For example, training of the internal team that will be developing and implementing a system is an integral part of the program instruction and implementation stages and contributes to the benefit provided by the system. We would endorse accounting that recognized this consequence by capitalizing such costs as part of total development costs. On the other hand, costs invested to train users of a new system are transitory, providing some benefit but for no distinguishable period. These should be expensed.

The PSOP prohibits capitalization of overhead costs on grounds that the measurements are "too imprecise." We disagree with this conclusion, and urge AcSEC instead to eliminate from the SOP any specific guidance on treatment of overhead costs.

Ordinarily, our view would be that "clear guidance" is "better guidance." In the current environment, however, we believe that the PSOP approach raises an unnecessary and imprudent threat. The environment in which we, our peers and our auditors attempt to operate has changed materially in recent times, to the point that very little can be "assumed" to be safe from reversal by regulators. We have seen an increasing parade of harsh challenges to and restatements of positions that were entered into in good faith and in the strong belief that resulting financial statements were true and fair. In view of the hard-line positions to which financial statements are being subjected, we believe that there is unacceptable risk that arises from introduction of any accounting ambiguity.

The risk that we see from an SOP issued in this form is a risk associated with overhead included in the basis of an asset — any asset. Consider:

More recent literature — SFAS No. 91 and Statements of Position 96-1 and 93-7 —

excludes certain overhead, most notably depreciation, from associated assets and liabilities.

No authoritative literature explicitly permits capitalization of overhead. One can infer under ARB 43, Statement 3 that such capitalization for inventories is appropriate, but it is enlightening that, under that literature, GE excluded significant overhead from inventories until 1987.

Although this line of challenge is fairly recent, one can now envision a regulator's concluding that, since overhead is not required to be included in inventory by ARB 43, it is more consistent with current accounting to require that such costs be written off. Such an answer would be an enormously negative event, and one that AcSEC should take extreme care to prevent.

Without having surveyed others on this topic, it would be surprising if any reporting entities excluded overhead from construction of fixed assets. Nor, in our view, would it be representationally faithful to exclude such costs. But measurability for fixed assets is surely no easier than it is for advertising, loans or software. Allocation of EDP costs, on the other hand, is a real-world undertaking often having cash financial implications, and cost allocation systems are sometimes as sophisticated as any inventory cost accounting system. Thus, we find that the attempt in the PSOP to isolate this conclusion to software is not only not reflective of the state of accounting systems, but we also find the justification strained beyond credibility.

It seems that the only means of addressing the issue of how much overhead should be recognized is to do so directly as a separate AcSEC accounting project, and to include fixed assets and inventories along with reconsideration of conclusions on advertising, software and environmental liabilities.

Question 6 — Determination of Whether Software Is Internal Use

We are not aware of instances in which the guidance in the PSOP is insufficient.

Question 7 — Accounting for Software That Is More Than Internal Use

We do not see a practicable alternative to the approach in the PSOP.

Question 8 — Distinction Between Upgrades/Enhancements and Maintenance

We believe that the guidance in the PSOP is operational.

Other Comments

We agree with the PSOP's conclusion not to add any specific new disclosures and are certainly not in favor of adding to GAAP's already overburdened list of required disclosures. Nevertheless, we point out the inconsistency with SFAS No. 86 in this area. That Statement requires specific disclosure of unamortized balances and amortization expense. The rationale for the SOP's improved treatment should be discussed in the final document.

The PSOP indicates that it does not change any of the provisions of SFAS No. 86. While literally true, it is clear that the SOP will significantly change how many entities have been defining "external use" for purposes of applying SFAS No. 86. Scope of that Statement was vague, and the rather broad guidance of the FASB article referred to in paragraph 41 of the PSOP has often been used to define many types of software as <u>external</u> that would now be defined as <u>internal</u> by the PSOP (e.g., examples (5), (6), (7) and (8) in Appendix A). Given the potential for a significant impact on the future application of SFAS No. 86, we believe the discussion in paragraphs 41 and 42 needs to be addressed prominently in the scope section of the SOP.

* * * * *

We shall be pleased to respond to any questions regarding this letter.

Sincerely,

P. D. Ameen

Division for CPA Firms

April 17, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Exposure Draft on Proposed Statement of Position "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" - File 4262

Dear Mr. Noll:

One of the objectives the Council of the American Institute of CPAs established for the Private Companies Practice Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective.

TIC has reviewed the above referenced exposure draft and is pleased to provide the following comments.

Specific Issues for Comment

Recognition as an Asset and Amortization

TIC supports the conclusions incorporated into the ED. TIC agrees that the costs of computer software developed or obtained for internal use do meet the recognition criteria in FASB Concepts Statement No. 5, and also do meet the definition of an asset as defined in FASB Concepts Statement No. 6, and should be accounted for as such. TIC also agrees that entities should not have the option to expense costs of computer software developed or obtained for internal use. Comparability between enterprises is important to maintain.

TIC agrees that the proposed SOP should not specify a maximum period for amortization or methods of amortization. The accounting guidance does not specify asset lives or methods of depreciation for most other assets. Software developed or obtained for internal use should not be treated differently. Furthermore, the expected useful lives and appropriate amortization methods will vary substantially between companies.

Impairment

The members of TIC agree that impairment should be recognized and measured in accordance with the provisions of SFAS 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. However, they believe that this guidance is very difficult to implement for internally used software costs. This proposed SOP gives one limited example of the application of SFAS 121 to software developed or obtained for internal use (paragraph 74). The members of TIC believe that additional examples of the application of SFAS 121 to software developed or obtained for internal use are necessary if comparability between companies is to be achieved.

The members of TIC offer the following scenario typical to their clients. In many of their clients, high level management or owners of the firm may be involved in the development of software for internal use. Their compensation may be excessive as compared to what an enterprise would ordinarily pay for programmers or others involved in a similar project. Furthermore, a large element of their compensation may be discretionary bonuses which are motivated by factors other than the development of the internal use software.

Paragraph 28 states that impairment has been deemed to occur when the costs exceed the amount originally expected to develop the software. However, it is quite possible that the enterprise would accumulate costs using the criteria in the SOP which are not excessive in comparison to their original estimates, yet are excessive in relation to what the fair value of the software might be.

The members of TIC feel that some additional guidance is needed to further clarify the following questions:

- Should total compensation be the basis for capitalization or should there be some other criteria?
- If the capitalization of costs becomes excessive, at what point should the capitalization cease?

Also, paragraph 28 uses the terminology "*operational* computer software" which suggests that SFAS 121 provisions should apply only upon the point when the software is functional. The members of TIC believe that this terminology is misleading as impairment should be evaluated, in many instances, prior to the time when the software is functional. The example should be modified to define "operational computer software" or other terminology should be used.

Technological Feasibility Criteria

This proposed SOP states that it does not require that an entity meet technological feasibility criteria similar to that established in SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed.* TIC believes that this proposed SOP in fact does require that an entity meet technological feasibility criteria, but that those criteria are more easily demonstrated to have been met, and are defined somewhat differently for software developed or obtained for internal use due to the higher level of commitment to the project when it is begun. TIC believes that the assumption that technological feasibility has been demonstrated when the project is begun should be acknowledged in the proposed SOP.

Costs that should be Capitalized

TIC agrees that this proposed SOP should use SOP 93-7, *Reporting on Advertising Costs,* and SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* as a basis for determining the kinds of costs of computer software developed or obtained for internal use that should be included in amounts reported as assets. TIC also agrees with AcSEC's observation that some costs, such as allocated overhead, may be part of the overall cost of assets, but it is appropriate to exclude these costs from capitalization due to their impreciseness and also their probable immateriality. TIC also notes that this accounting treatment appears to be consistent with SFAS 60, *Accounting and Reporting by Insurance Enterprises,* which allows for capitalization of the costs incurred in the acquisition of new and renewal insurance contracts, with acquisition costs being defined as those that "vary with and are primarily related to the acquisition of insurance contracts."

TIC also agrees that interest costs incurred while developing internal-use computer software should be capitalized in accordance with the provisions of SFAS 34, *Capitalization of Interest Cost.*

We appreciate this opportunity to present these comments on behalf of the Private Companies Practice Section. We would be pleased to discuss our comments with you or representatives of the Accounting Standards Division at your convenience.

Sincerely,

James A. Koepke, Chair
PCPS Technical Issues Committee

JAK:ses
File 4262

cc: Jane Adams, AICPA Director, Accounting Standards (for AcSEC)
PCP Executive and PCPS Technical Issues Committees

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Gerard J. "Rusty" Brinkman
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Cincinnati
Bell

April 17, 1997

Mr. Dan Noll
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1211 Avenue of the Americas
New York, NY 10036-8775

Cincinnati Bell Inc. ("CBI") is pleased to have the opportunity to respond to the exposure draft of the proposed Statement of Position ("SOP") on *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.* The comments within this letter are representative of CBI as a whole and may not necessarily reflect the individual views of the many affiliated companies of the company.

While this letter addresses the specific issues raised in the exposure draft, CBI agrees with the concepts of capitalization of costs for the acquisition or development of software for use within our company. We endorse the thrust of the proposed SOP because it will require companies to capitalize costs and subsequently amortize those costs over a term which will match the economic benefits derived from the software. The SOP defines the asset which can be significant not only in dollars but also in terms of importance to a company. As technology grows, so to will the need to acquire or develop more technologically complex software which will allow an company to stay competitive.

The scope of the SOP does not include costs of reengineering operations or costs of converting data from old to new systems (paragraph 10). We believe expansion of the SOP to these areas would benefit many companies due to frequency of occurrence and the association with development or acquisition of software. CBI feels if this area is omitted, industry will continue with inconsistent practices which this SOP aims to eliminate.

You requested comments regarding eight specific issues discussed in the proposed SOP. Our response to these issues along with the individual questions are noted below.

Issue Number 1

Should the costs of computer software developed or obtained for internal use be recognized?
Should entitles have the option to capitalize or expense such costs?
Do the benefits of reporting those costs as assets exceed the costs of such reporting?
What are the costs of reporting?

We support the establishment of an asset representing the costs of developing or obtaining computer software for internal use. We believe the costs which meet the criteria defined in the SOP should be required to be capitalized. The only exception which an entity can employ is where a company's policy for immaterial acquisitions allows for expensing. Currently, practice among many companies is to expense acquisitions under a defined dollar amount because capitalization of small dollar amounts would incorporate costs of reporting exceeding the benefits of such reporting

CBI believes computer software meets the three essential characteristics of an asset as cited in FASB Concepts Statement No. 6. Additionally, computer software either developed or acquired should be capitalized when an entity can demonstrate a probable economic benefit and technological feasibility. We agree with the conclusion reached in paragraph 56. However, we believe the SOP should incorporate technical feasibility in the capitalization criteria as prescribed in SFAS No. 86 *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed.* CBI believes having similar criteria will provide clarity to entities for capitalization of software costs.

Issue Number 2

Should the SOP specify that amortization should not exceed a maximum period?
If so, why, and what maximum period should be specified?
Should the SOP require certain methods of amortization?
If so why, and what methods should be required?

Management must use judgment in the estimated useful life of the software. CBI agrees with the conclusion reached in paragraph 75. Because technology changes rapidly, a life which is reasonably short or an estimated life that would fully amortize the cost until a system replacement is considered would be an appropriate life.

Amortization should begin once capitalization ceases and when the software is in use. The proposed SOP should recognize that there may exist a period of time between the completed testing and full implementation of the computer software.

Issue Number 3

Should impairment of internal-use computer software assets be recognized and measured according to SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of?*
If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment?
If not, how should entities recognize and measure impairment of internal-use computer software assets?

Computer software which does not perform according to its intended use or developed incompletely has little or no value to an entity. Therefore, the software should be carried at the lower-of-cost or fair value, less costs to dispose or sell.

Impairment may occur when a "significant change occurs in the extent or manner in which the software is used" as noted in paragraph 28. For example, when a general ledger system is acquired which has a report writing module included and an entity intended to use the module for consolidating entities but subsequently changes its approach to use a more efficient PC-based system, this change does not indicate impairment. The entity may use the reporting module for other types of reporting and therefore, the portion of the system still be determinable value. If, on the other hand, the report writing module is not used and the entity can reasonably determine the cost associated with the module, then one could argue that impairment or loss of value has occurred.

CBI believes another impairment standard is not necessary and that provisions of SFAS No. 121 are adequate in determining impairment.

Issue Number 4

Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?
If so, what are those criteria?

As stated previously, CBI believes that technological feasibility along with probable economic benefits must be identified for costs to qualify for capitalization. Software which is feasible of completing the tasks incorporated in its design should be an element in the asset. Costs incurred for software obtained or developed which is not technically feasible has little or no value. Therefore, CBI reiterates strongly its desire to have an entity meet technological feasibility as a criteria for capitalization of costs, provided these costs are not research and development.

Any costs incurred prior to establishing technological feasibility should be expensed.

Issue Number 5

205

Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets?
Why?
What costs should included or excluded?

Using incremental direct costs for capitalization is an approach which provides the least amount of subjectivity in the costs used for capitalization. When acquiring computer software "off the shelf" such as a spreadsheet program, the amount of costs capitalized include the purchase price and associated sales taxes and delivery charges (shipping and handling). Costs, such as the payroll and payroll taxes for the employee installing the software, would also qualify for capitalization under the provisions of the proposed SOP. Entities however, will recognize the onerous and costly tasks of recordkeeping for such a process. The propensity for companies will be to capitalize the direct purchase costs and expense the indirect installation costs due to their immateriality.

For computer software which is developed, CBI concurs with the SOP that direct salaries and wages and payroll-related costs for the personnel involved in the project would qualify for capitalization. External costs for consultants, legal fees for contracts and other professional fees are also direct costs which logically would be included and qualified for capitalization. For example, if a consultant is hired to find a time reporting system for a company and the consultant arranges vendor presentations in response to a proposal request, the charges incurred from the consultant would qualify for capitalization.

The SOP's scope should include the conversion of data from an old system to a new system which has been developed or acquired. For example, if a company acquires or develops a fixed asset system, the process of converting the multiple asset lives and basis information is significant and an integral part of implementation. Likewise, if a new general ledger is bought or developed, the transaction history is typically converted to the new system allowing the company to abandon the old system. The SOP should allow for companies to capitalize the costs of converting old data.

Paragraph 16 of the proposed SOP denoted the various stages of computer software development, however, on the front-end of a development project when multiple alternatives are present, consideration should be given to allowing capitalization of costs incurred for the alternative chosen. For example, if several consultants are contacted to make presentations for a given project and one consultant is hired to begin coding, can the costs incurred by the consultant chosen in the preliminary stage be capitalized? CBI believes the direct costs should be capitalized while any other indirect costs incurred, such as those from other consultants, be expensed.

Distinction has not been made for the development of applications of given software from the actual software acquired. For example, if a software application is purchased such as Hyperion Enterprise and is used to create an executive information system, can these development costs incurred to create this "system" be capitalized? CBI recognizes that the costs of the Hyperion Enterprise software in this example, can be capitalized, however, the SOP is not clear regarding the additional development costs. Another example would include the creation of applications of "systems" from spreadsheet software such as Excel or Lotus 1-2-3. These applications definitely accrue benefits to the company but should these development costs be considered? CBI concludes that these costs do qualify for capitalization because these applications have value to the company. If a procedure is enhanced by the use of these applications then capitalization should be allowed. In addition, the proposed SOP does not mention the associated documentation of the software or application of the software. Paragraph 10 should include this distinction as well. CBI also recommends the cost of documentation be included as part of the capitalization process.

In paragraph 17 of the proposed SOP, maintenance and training costs are specifically excluded from capitalization when properly identified. Paragraph 23 states that capitalization should cease when the computer software is "ready for its intended use." The paragraph goes on to state that computer software is "ready for its intended use after substantially all testing is completed." If a programmer designs, codes and tests developed software and no other person knows how to access or use the software, is the software "ready for its intended use" without training the users of the software. The original design specifications would include the identification of the users of the software and the objectives of performance of the developed software. Wouldn't the costs such as this be similar to the installation costs of machinery or other types of capital assets? CBI proposes training costs of personnel be included in capitalization up to the initial time of implementation of the software. Having indeterminable life is not a disqualifying factor, we believe. Additional training costs, along with maintenance costs as specified in paragraph 25, should be expensed when incurred.

CBI concurs with the capitalization of costs for upgrades and enhancement as denoted in paragraph 24.

Issue Number 6

Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use?
Is the guidance appropriate?
Why?

Paragraph 9 possesses the proper answers to this issue. CBI concurs with the conclusions reached paragraph 38, given the opportunity to apply these provisions to individual modules in the computer software. When *the intent to sell exists, an entity* should follow the provisions of SFAS No. 86 as stated in the SOP. We concur that it is impractical to allocate costs between internal-use software and software to be marketed.

Issue Number 7

Software is sometimes developed or obtained for both internal use and external marketing. Some believe the costs should be allocated between internal use and software to be marketed. Do you agree with this approach in the proposed SOP that requires an entity to follow guidance in either this proposed SOP or FASB Statement No. 86. but not both?
If not, how should these costs be allocated?

Deferring revenue recognition until all costs of the software are recovered appears to be a reasonable approach. CBI concurs with the conclusions reached in paragraph 40 citing that sufficient guidance is found in SFAS No. 86 and this proposed SOP.

Issue Number 8

The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Using existing standards and practices for other types of capital assets should extend to computer software. Where significant functionality is added or significant improvements in the performance can be measured, then the additional costs should be capitalized. Costs for minor corrections to programming that have limited or immeasurable improvements in the performance or efficiency of the software should be considered maintenance and expensed when incurred.

In conclusion, we appreciate the attempts by the AICPA to resolve inconsistencies currently in practice involving capitalization of software costs. Such consistency in reporting will help to minimize errors and inconsistencies, as fewer adjustments will be made.

Sincerely,

THE STATE OF WYOMING

Public Service Co.

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April 17, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File Reference No. 4262

Dear Mr. Noll:

The Wyoming Public Service Commission ("WPSC") hereby submits its comments on the Proposed Statement of Position on Accounting for the Costs of Computer Software Developed or Obtained for Internal Use ("Proposed Statement"). The WPSC is the Wyoming state utility regulatory agency which has jurisdiction, among other matters, to set the rates of Wyoming public utilities. The WPSC, therefore, has an interest in accounting and reporting matters, especially when they may have a significant impact on the operations and practices of public utilities. Our comments will focus on the impact that the Proposed Statement will have on the financial statements of rate-regulated public utilities.

The Proposed Statement, if adopted, would require some consistency in accounting practices related to the costs of software. Utility regulators have been examining this issue for several years and have found no consistency or comparability across industries or even across companies within an industry. Regulators' concerns on this matter were formally expressed to the Federal Communications Commission in January 1994 when the National Association of Regulatory Utility Commissioners ("NARUC") requested the establishment of a Notice of Inquiry to seek information and comment concerning the issues surrounding the current local exchange carriers' accounting for operating system software purchases and development. The WPSC supports the concept of developing accounting standards for these costs because there is now no authoritative guidance provided on this issue by Generally Accepted Accounting Principles ("GAAP") and because of the current inconsistency in industry accounting practices.

The threshold question for the development of accounting standards for software costs is whether or not they are properly defined and categorized as assets. The WPSC believes that software costs should be categorized as assets. Software costs are identifiable, have determinate lives, and relate to probable future economic benefits. This meets the criteria which are used to determine whether a cost constitutes an asset. These criteria apply whether the software being discussed relates to software as part of a telecommunications switch or to software used for a customer accounting and billing system. It is not consistent with other accounting standards to allow companies to persist in the often used current accounting practice of allowing costs that benefit multiple years to be recognized as an expense all in one year.

Once its status as an asset is established, the appropriate amortization period for the software costs must be determined. The Proposed Statement indicates, at paragraph 30, that "The costs of computer software developed or obtained for internal use should be amortized in a systematic and rational manner over the estimated useful life of the software." The statement goes on, at paragraph 31, to list several factors that impact the estimated useful life, including: obsolescence, technology, and competition. The WPSC agrees with the Proposed Statement on both of these considerations related to the amortization period. However, we do not believe that this in any way implies that the software must necessarily be amortized over the same life as the hardware with which it is associated. For example, a telecommunications switch may be depreciated over a ten year period, but may require an updated software package at year five in order to continue providing the functions and features that are demanded by customers. In this example, the original software should be amortized over a five year period, not the ten years associated with the switch. It is not logical to allow either the original software or the software installed in year five to be expensed, but that is exactly what some companies are doing today. Initial software is being capitalized with the hardware it supports but upgraded or enhanced operating system software is being expensed. While today's practice may be consistent with practices set forth by regulatory agencies, such as the Federal Communications Commission, it is not consistent with the matching principle and other accounting theory. It is logically inconsistent and treats essentially identical assets very differently.

While the WPSC supports the Proposed Statement, we are concerned about one issue that is specifically removed from the Proposed Statement's applicability. Paragraph 10 states,

> Accounting for costs of reengineering operations, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. Similarly, accounting for costs of converting data from old systems to new systems is excluded from the scope of this SOP.

There are significant costs currently being expended by the utility industry on new accounting systems, new customer information and billing systems, remote customer service operations, and other internal operations, many of them directly associated with reengineering plans. It is expected that these types of costs will continue to grow, as utilities restructure their operations to transition to a more competitive environment and as computer issues related to the new millennium are addressed. These costs should not escape the standard setting process.

Finally, many may ask why the regulators are concerned about costs being either expensed or capitalized since more and more utilities are moving away from cost-of-service based rate of return regulation. We care for two reasons. First, this transition is not universal. The majority of regulated companies in Wyoming continue to be cost-of-service regulated. For these companies, a change from capital to expense treatment (or vice versa) will potentially have an impact on rates. Further, a significant amount of time is spent in some proceedings arguing about the appropriate economic lives that should be used for setting rates. Second, as utilities move into the competitive environment, inconsistent accounting practices may provide an artificial competitive advantage or disadvantage to one of the competitors in the market. Regulators are not only responsible for setting rates, but have taken on the new responsibility of setting the standards to make sure the transition to competition is fair and that it really occurs.

The WPSC appreciates the effort that has been put into this Proposed Statement and overall, we support the Proposed Statement. We do ask that you consider omitting the exclusion that is currently proposed for reengineering costs. We look forward to additional opportunities to work with you on this Proposed Statement and other accounting matters, and we would be pleased to discuss our own observations with you in greater detail.

Yours very truly,

WYOMING PUBLIC SERVICE COMMISSION

Steve Ellenbecker

STEVE ELLENBECKER, Chairman

Doug Doughty

DOUG DOUGHTY, Deputy Chairman

Kristin H. Lee

KRISTIN H. LEE, Commissioner

Heller International Corp.

April 17, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

This letter is in response to the Accounting Standards Executive Committee's (the AcSEC) December 17, 1996 Proposed Statement of Position related to Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (the Statement). While the AcSEC has invited comments on all matters in the Statement, we have chosen to respond to questions one and five.

We recognize the importance of this issue and support the AcSEC's efforts in addressing computer software developed or obtained for internal use. We agree that current practices followed in some areas of computer software accounting are in need of revision, and that, particularly, accounting for internal-use computer software should be evaluated for improvement.

We believe that computer software developed or obtained for internal use closely matches the characteristics of long-lived assets such as property, plant and equipment. Therefore, in order to remain consistent, internal-use software should be recognized as an asset and entities should not have the option to expense these costs. Consistent with the fixed asset model, the benefits, particularly comparability, of reporting those costs as assets exceeds the costs of such reporting. We support the AcSEC in requiring long-lived asset capitalization of:
external direct costs of materials and services
payroll and payroll-related costs for employees who are directly associated with and who devote time to the project (to the extent of the time spent directly on the project)
and interest costs incurred in developing internal-use computer software.

We also agree that research and development costs should be expensed as they are incurred in accordance with the provisions of Financial Accounting Standards Board (FASB) Statement 2, *Accounting for Research and Development Costs*. We share the AcSEC's opinion that training costs and maintenance fees should be expensed as incurred or recognized over the maintenance period, respectively. The Statement, however, should provide some clarification regarding implementation costs, costs to convert data, and capitalization of interest costs.

The Statement's definition of the types of costs considered as implementation costs needs clarification. We consider installation costs and data conversion costs to be components of the implementation phase because installation occurs after testing is substantially complete. These costs are necessary to prepare an asset for its intended use, which we feel should be capitalized as opposed to expensed as proposed under the Statement. The capitalizable costs of long-lived assets, such as property, plant and equipment, have traditionally included all reasonable and necessary expenditures to make the asset ready for use, including installation costs. Therefore, discontinuing capitalization of computer software costs when the software is available for "general release to customers" (similar to when testing is substantially complete) and expensing all "customer support", including installation assistance, as defined in FASB Statement 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed,* would provide inconsistent treatment. Revenue can only be obtained from internal-use computer software if and when it is implemented, because it must be utilized, not sold, in order to generate revenues or effectively support revenue generating activities.

We believe that the criteria determining capitalization of internal-use software should rely on the concept of matching revenues and expenses to the period benefited. Computer software to be sold, leased or otherwise marketed is able to generate revenue before it is installed because it is ready for general release (sale) to customers, therefore, costs should begin to be recognized at that time; and subsequent activities like customer support are services which can be marketed and sold separately for discrete revenues. However, internal-use computer software more closely adheres to the revenue and expense characteristics exhibited by property, plant and equipment whose revenue stream does not begin until installation is complete. Thus, installation costs for internal-use computer software should be capitalized.

Guidance covering costs of data conversion have not been addressed and is excluded from the scope of this Statement. We feel that this will result in inconsistent interpretation and treatment by entities, thereby decreasing the comparability of their financial results. Based on the reasons stated above, we recommend that costs of converting data be included in the definition of implementation costs and that such costs be capitalizable for computer software developed or obtained for internal use.

Lastly, the Statement relies on FASB Statement 34, *Capitalization of Interest Expense*, but varies the treatment of interest expense for computer software depending on whether it is developed or obtained for internal use. The acquisition period criteria required by FASB Statement 34 appears to be applied only to software developed internally rather than software obtained for internal-use. The Statement does not consider the possibility that computer software obtained, not developed, for internal use could meet the requirements in paragraph 9 part (a) of FASB Statement 34, thereby permitting capitalization of interest costs. Therefore, all interest expense related to preparing obtained computer software for internal use is required to be expensed. For the same reasons listed above, we believe that any internal-use computer software can have significant testing and implementation costs, and, therefore, an acquisition period. Thus interest expense accumulated during the acquisition period, should be capitalized and amortized over the useful life of the software to better match the revenue streams generated by internal-use computer software.

We would be pleased to discuss these comments in further detail with the AcSEC, should there be any matters requiring clarification.

Sincerely,

Lawrence G. Hund
SVP & Controller
Analyst

Joseph.Doolan
Group Finance Officer

Sandra Fey
Sr. Financial

Metropolitan Life Insurance Company
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MetLife

April 11, 1997

Mr. Daniel Noll
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Donnelly:

We have reviewed the AICPA's recently issued Exposure Draft of a Proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* and generally agree with the Accounting Standards Executive Committee that certain costs related to software development should be capitalized. The following are Metropolitan Life's comments on the SOP:

1. The proposed SOP states that amortization of capitalizable costs should begin when the software is ready for the intended use. Intended use is defined as completion of substantially all software testing. It is possible to complete the testing of software and not be able to utilize it for the intended use because data are not ready to be converted. Further, conversion issues may impair an entity's ability to use the software when it is available for use. We believe the SOP should require amortization to begin when an entity is able to utilize the software for it's intended use.

2. The proposed SOP excludes accounting for the cost to convert data from an old system to a new system. The conversion of information into the format of a new system is an integral part of developing the new system for an intended use and frequently represents a significant portion of the overall system development costs. Therefore, we believe the SOP should be revised to provide an entity the option to capitalize these costs.

3. The proposed SOP allows for the capitalization of external direct costs, payroll and payroll-related costs for employees, and interest expense. There is no provision for the capitalization of other internal costs that are directly related to the internal-use computer software project. To the extent these costs are identifiable and directly related to the project, we believe they should be capitalized and recommend that the SOP be revised to include such a provision.

We recognize that the SOP addresses only certain computer software costs and that our comments 2. and 3. above would expand the scope of the SOP. Nevertheless, we believe the issues we have addressed are important enough that the scope of the SOP should be expanded. The insurance industry is constantly changing which requires regular evaluation and enhancement of computer software. The proposed SOP, taking into consideration the above comments, will allow companies in our industry to report the impact of these changes in a manner which better matches revenue and expenses and more accurately reflects the economics of our business.

Sincerely,

H. Wayne Thrasher

H. Wayne Thrasher, CPA
Vice-President and Senior Controller

Mobil Corporation

3225 GALLOWS ROAD
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M.F. KEETH
CONTROLLER

April 17, 1997

Mr. Daniel Noll
Technical Manager
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1211 Avenue of the Americas
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FILE 4262 PROPOSED STATEMENT OF POSITION - ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

Dear Mr. Noll:

We are pleased to comment on the Proposed Statement of Position (Proposed SOP) entitled, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

Mobil's accounting policy for the cost of internally used software is to expense it as incurred. Over the years, we have had many discussions about this policy because there are substantive views on each side of the issue and the Proposed SOP has articulated well those in support of capitalization. The primary reason that we have maintained our policy is that we do not believe that, once capitalized, the appropriate amortization period can be determined.

Generally, the period that depreciable assets provide probable future economic benefits can be reasonably determined through either engineering studies, historical perspective, or defined economic usage. Computer software can be very different, particularly when it is associated with a stand alone system (e.g., accounting, engineering, etc.) as opposed to a system embedded in a manufacturing process or machine. In the latter case, we would argue that the system is part of the process and would be depreciated on the same basis as the machines it is running. Usually, those systems are part of the cost of the asset being acquired and the issue of accounting for software costs does not arise. It is the cost of the stand alone systems that are the assets themselves and which are addressed in the Proposed SOP that are the most controversial.

In paragraph 68 of the Proposed SOP, ACSEC referenced SOP 93-7 as support for the types of costs that should be capitalized. We find this interesting because we would use SOP 93-7 as support for expensing computer software costs. SOP 93-7 requires that only direct-response advertising costs be capitalized. Other advertising costs are expensed as incurred or when the advertising is first used. While ACSEC believes that those costs have probable future benefits that meet the definition of an asset, "those benefits cannot be measured with the degree of reliability required to report an asset in the financial statements" (paragraph 61 of SOP 93-7). We believe that this argument is applicable to the reliability of the measurement for the useful life of computer software used internally.

We acknowledge that computer software costs result in future economic benefits, but we question whether a meaningful useful life can be estimated in compliance with paragraph 31 of the Proposed SOP. Taking into account our rapidly changing business environment and the continuing expansion of new technology, it is not practicable to expect that a reasonable estimate can be made. We have experienced systems that were expected to be the best technology to last for 15 years but had to be replaced within a few years after implementation and, conversely, we have been using some systems far beyond the length of time that was originally expected. The estimated useful life of computer software is simply not a reliable measure and using it to amortize capitalized costs is essentially an exercise in smoothing software expenditures over an arbitrary period. In our opinion, this does not give a better answer than simply expensing the costs in the year incurred.

While we prefer expensing computer software costs as incurred, we recognize that the unique characteristics of these costs make it difficult to definitively categorize them as either expense or capital. There are similar diverse views on oil and gas accounting, which has resulted in the SEC's accepting both the successful efforts and full cost methods. We believe that the final SOP should take a similar approach and permit either expensing or capitalization of the costs of computer software used internally but require that, once adopted, the policy should be consistently applied.

Very truly yours,

M. F. Keeth

M. F. Keeth

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STATE OF FLORIDA

Commissioners:
JULIA L. JOHNSON, CHAIRMAN
SUSAN F. CLARK
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Public Service Commission

April 14, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA, 1211 Avenue of the Americas
New York, New York 10036-8775

Re: Accounting for the costs of computer software developed or obtained for internal use.

Dear Mr. Noll:

Attached are the comments of the Florida Public Service Commission.

Sincerely,

Cynthia B. Miller
Senior Attorney

CBM:jmb

COMMENTS OF THE
FLORIDA PUBLIC SERVICE COMMISSION
Accounting For The Costs Of Computer Software Developed Or Obtained For Internal Use

The Florida Public Service Commission (the Commission) commends the Accounting Standards Executive Committee (AcSEC) for its efforts in responding to the issue of accounting for computer software costs developed or obtained for internal use. The following comments address three basic positions:

1. The cost of computer software developed or obtained for internal use should be classified as an asset;

2. Uniform accounting standards for capitalization versus expensing of computer software costs need to be established; and,

3. The initial installation of software costs should be capitalized and amortized or depreciated over the life of the associated computer or switch.

The Commission agrees with the exposure draft that the cost of the addressed computer software should be classified as an asset. The Commission further concurs with the basis for the AcSEC's conclusion as stated in Paragraphs 51 and 52. The FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as "*probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.*" The Commission believes that the costs incurred to develop or obtain software used internally are for the purposes of reducing costs, operating more efficiently, serving customers more effectively, and gaining competitive advantages. These purposes fall easily within the definition of an asset providing probable future economic benefit as stated in the Concepts Statement No. 6. Additionally, they meet the criteria as set forth in the FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises:* definitions, measurability, relevance, and reliability.

The Commission concurs with AcSEC that there is nonuniformity in accounting treatment of software costs. There is a disparity between the industries as well as the companies within an industry. Currently, the electric industry classifies the majority of the software costs as intangible assets and generally amortizes them over five years. The disparity within the electric industry is the materiality threshold for capitalizing versus expensing. Currently, the threshold for Florida regulated companies ranges from $500 to $1,000,000. The majority of the telecommunications companies expense a significant portion of software costs as a period cost. Additionally, the Commission concurs with the AcSEC that companies should not have the option of capitalizing or expensing computer software costs. (Paragraph 60) The exposure draft would help minimize the inconsistencies that currently exist.

In situations where the software is an integral part of another asset, such as with a telecommunications switch, the Commission believes initial software costs should be capitalized and depreciated over the life of the associated long-lived asset regardless of the frequency of change out. This would recognize a base level of software costs during the life of the asset. In regulatory terminology, software would be considered a minor item of property. We oppose the current practice of expensing initial software costs since they can represent a significant portion of the cost of the associated asset.

Paragraph 24 of the Exposure Draft states that costs of upgrades and enhancements that result in significant additional functionality should be capitalized. The Commission believes that any software upgrades or enhancements should be expensed. A Commission staff survey identified that the telecommunication companies experience frequent upgrades of network software. Some of the companies change out or upgrade network related software as often as every six months. Part of the reason for such a churn is that vendors release frequent upgrades. If the company delays an upgrade of network software, network support from the vendor may become jeopardized. Additionally, the telecommunications companies have a vendor compatibility problem for network software. For example, a Northern Telecom switch cannot use AT&T software. Companies are captive to the vendor of the purchased switch. Because of this situation as well as for administrative ease, the current practice of expensing upgrades may be more appropriate.

Paragraph 30 states that capitalized software costs are to be amortized over a period of time determined by management. Paragraph 31 states that in determining the period, the companies should consider the effects of obsolescence, technology, competition, and other economic factors. Additionally, consideration should be given to rapid changes occurring in the development of software products, software operating systems, or computer hardware, and how frequently management intends to replace any technologically obsolete software or hardware. For telecommunications companies, the Commission believes that these paragraphs of the exposure draft would allow the current accounting practice of expensing the majority of the software costs to continue. Management could determine that the amortization period of these costs should be as short as 6 months. This would effectively result in the expensing of all software costs. On the other hand, the Exposure Draft does not give any guidance as to an acceptable maximum amortization period. The Commission therefore believes that the AcSEC should readdress this area. Additionally, the Commission believes that a maximum amortization period for capitalized software should be the life of the associated long-lived asset (the switch or computer). We believe the Exposure Draft, as currently written, will not accomplish the uniformity in accounting treatment the AcSEC is hoping to achieve.

In conclusion, the Commission commends the AcSEC for addressing the appropriate accounting treatment for software developed or obtained for internal use. We agree that there exists an inconsistency between industries and companies within a specific industry in accounting for these costs. For this reason, we encourage the establishment of standards that will minimize these inconsistencies.

The Walt Disney Company

April 17, 1997

Mr. Daniel Noll
Technical Manager-Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

We appreciate the opportunity to comment on the exposure draft proposed statement of position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (the SOP). It has been Disney's position for many years that costs incurred to develop or obtain software for internal use represent assets. We, therefore, strongly support AcSEC's efforts to issue a SOP formalizing a capitalization accounting model for internal use software.

The following responses address the specific issues raised by AcSEC in the SOP:

<u>Amortization</u>

We agree with AcSEC's position of not specifing a maximum amortization period or method of amortization. We believe that individual companies are in the best position to determine an appropriate life and method of amortization for software costs based upon the characteristics of the software and the intended use of the software by the company.

<u>Technical Feasibility</u>

We agree with AcSEC's position that technological feasibility criteria need not be met in order for an entity to begin capitalization of internal use software costs. It is our opinion that the costs of internal use computer software should be capitalized based on principles consistent with those used for fixed assets and should not follow those used for inventory as set forth in FASB No. 86.

Maintenance versus Upgrades

We agree with the premise that upgrades and enhancements that extend the life of software or increase functionality are to be capitalized and costs of ordinary maintenance activities should be expensed as incurred. However, it has been our experience that it is difficult to differentiate between the two in practice. We believe that the use of illustrative examples outlining the differences in the types of costs that should be expensed and those costs that should be capitalized would be very helpful in implementing the SOP.

Internal Use versus FASB No. 86

Disney concurs with the AcSEC position that if the intent to sell, lease or otherwise market the software is present then accounting prescribed by FASB Statement No. 86 should be required. It is our position that if the product is marketed then the more conservative inventory model should be followed and costs should be capitalized subsequent to achieving technological feasibility.

Other Comments

An area which we believe should be clarified is the definition of training costs. It is our interpretation that the training costs outlined in the SOP relate to end-user training. There are, however, training costs associated with training the project implementation team so that they may be familiar enough with the software to adequately analyze, design and implement the software package that is being developed. There are also costs involved in developing end-user training manuals and procedures. We believe these training costs differ from costs to train end users and should be capitalized as a cost of readying the software for its intended use.

© Disney

We would be pleased to discuss our comments with AcSEC at any time.

Very truly yours,

John J. Garand
Senior Vice President
Planning and Control
The Walt Disney Company

JJG:lb

© Disney

Chevron

April 16, 1997

Chevron Corporation
575 Market Street
San Francisco, CA 94105-2856

S. J. Crowe
Comptroller

Mr. Daniel Noll
Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

Thank you for the opportunity to comment on the Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," dated December 17, 1996.

While there has been no specific GAAP on subject topic, concepts/guidance derived from SFAS 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" have formed the basis for accounting for internal use software costs in Chevron Corporation. We are surprised to see a departure from some of these concepts. Specifically, we offer the following comments to the subject exposure draft (ED):

- **PARAGRAPH 11**

  The definition of "Internal Use" per the ED is considered to be very restrictive, especially as it relates to the requirement that no plan exist to market the software externally. This statement is very limiting, since there is always an element of optimism/hope that software developed for internal use **may be** marketable to others.

  We recognize that it is important to distinguish software developed with the ***primary*** goal of internal use vs. software developed for marketing purposes Hence, a less restrictive and more practical definition for "Internal Use" would be software developed for which:

  ◊ the **primary** purpose is internal use, and a **secondary** purpose , **if any**, is to market the software. Additionally, the software would be developed for internal use even **if no sale is contemplated.**

  ◊ the entity is not in the **primary** business to develop and sell software.

- **PARAGRAPH 19**

Per the ED, the costs of computer software developed or obtained for internal use should be capitalized as a long-lived asset. While it would be ideal to treat internally developed software and software purchased for internal use in a consistent manner (i.e., capitalized), we believe it is a simplistic approach and a departure from accounting concepts used as the basis for SFAS 86. One of the SFAS 86 major controls was the "net realizable value" test, which provided that software developed for external use has economic benefit outside the organization and hence could be capitalized, whereas software created for internal use generally had no economic benefit outside the organization for which it was developed and should be expensed.

The Board's position detailed in SFAS 86 also recognized that the majority of companies expensed costs of developing software for internal use, and that the Board was not persuaded that the current predominant practice was improper.

Based on the "net realizable value" concept and the Board's position relative to SFAS 86, Chevron has been in favor of capitalizing purchased software for internal use along with all third-party costs associated with making the software operational. Additionally, internal costs incurred for work under external supervision/direction to make purchased software operational is also capitalized. However, internal costs incurred to develop software for internal use have been expensed since there is generally no "net realizable value" for software developed for Chevron's unique applications.

- **PARAGRAPH 23**

Per the ED, capitalization ceases no later than the point at which a computer software is substantially complete and ready for its intended use. It is unclear if all costs (internal and external) related to customization, modification, interface with legacy systems and installation of purchased software are also capitalized.

Chevron's position is that all external costs incurred to make software operational should be capitalized. Additionally, company employee costs would be capitalized only if the employees were working under the direction/supervision of the third party to make the purchased software operational.

- **PARAGRAPH 26**

  Per the ED, costs of computer software developed or obtained for internal use should be capitalized to include only costs of payroll and payroll-related costs for employees who are directly associated with the project. Why not include general and administrative expenses and other cost elements such as rent, connectivity charges, desktop services, machine charges, license fees, etc.?

- **PARAGRAPH 33**

  For "Internal Use" software subsequently sold, the ED calls for proceeds to be applied against the carrying amount of that software and that no profit be recognized until aggregate proceeds from sales exceed the carrying amount. To deduct proceeds received from the carrying value of the asset contradicts the matching principle and is a departure from established accounting concepts. We would recommend that revenue generated from software be treated as miscellaneous revenue.

Thank you once again for the opportunity to comment.

Sincerely,

TEXTRON

Textron Inc.

40 Westminster Street
Providence, RI 02903
401 / 421-2800

April 16, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

File # 4262

Dear Mr. Noll

Textron appreciates the opportunity to comment on the Exposure Draft of the proposed AICPA Statement of Position on "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Textron is a global multi-industry company with businesses in the aircraft, automotive, industrial and finance markets.

We support AcSEC's proposal. We believe that there is a future economic benefit associated with the development of significant internal computer software projects and that the capitalization of such costs is appropriate. We have the following additional comments:

Overhead and Training Costs

The proposed SOP would not allow capitalization of overhead costs or training costs as costs of internal-use software. In certain circumstances, incremental overhead costs may be directly attributable to the software development effort. We believe that identifiable incremental overhead costs that can be directly linked to the development effort should be eligible for capitalization. In addition, we believe that in certain circumstances, training costs should be eligible for capitalization. Much of the value of internal use software can only be realized by an entity if it's users are properly trained in the software's functionality. In fact, without user training, internal-use software arguably has little value to an entity. The value of internal-use software is in large part created through proper training and ultimately realized through the software's use in operations. In addition, we do not believe that internal-use software projects can be considered "complete and ready for its intended use" in the absence of trained users. Therefore, we believe the training costs incurred during the implementation stage should be eligible for capitalization.

Structure of the Amortization Period

The proposal does not establish a maximum amortization period. An entity should consider the effects of obsolescence, technology, competition and other economic factors when determining the useful life of the software. We believe that the facts and circumstances in each case will be different, and that a maximum amortization period should not be established.

Maintenance vs. Upgrades

The proposed SOP provides that costs of "significant upgrades and enhancements to internal use software should be capitalized if it is probable that those expenditures will result in significant additional functionality or a significant extension of the software's useful life." Maintenance activities would be expensed. We believe that distinguishing maintenance activities from upgrade and enhancements may be difficult. In the context of software, a significant extension to a useful life might be one year (25% of an original life of four years), and might be the result of maintenance activities. Additional guidance is necessary.

Cash Flows

The proposed SOP would require capitalization of payroll and payroll-related costs of employees who are directly associated with the project. We assume that such costs and other costs of capitalized software would be presented as a cash flow from investing activities in a statement of cash flows prepared in accordance with SFAS 95.

****

Textron appreciates the opportunity to comment on the proposed SOP. Questions should be addressed to Chris Rees at 401-457-6044.

Very truly yours,

W. Chris Rees

W. Christopher Rees
Director, Financial Reporting and Accounting

Author: PC:Foonman1@aol.com at INTERNET
Date: 4/18/97 3:37 PM
Priority: Normal
TO: Daniel J. Noll at AICPA3
Subject: Exposure Draft Comments
------------------------------------ Message Contents ------------------------------------

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA, 1211 Avenue of the Americas
New York, NY 10036-8775

Re: Exposure Draft-Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll,

As a financial analyst, in the telecommunications software industry, and former accountant, the exposure draft was reviewed to determine its' implications and next to comment on points of concern. The proposed statement seeks to broaden the scope of FASB Statement No.86 by addressing the method of treatment of software purchased or developed for internal use. It reasoning for broadening the scope is "to help reduce the inconsistencies that currently exists"(Paragraph 3). It would appear the statements in paragraphs 11,13, and 17 leave room for companies to make plausible statements to their management and/or auditors in order to achieve their own unique financial objectives quarter by quarter. For instance, in paragraph 13 where a "past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale..". It is a reasonable concern that based on the many scenarios listed in the SOP paragraphs above, that there will still be many inconsistencies in reporting . Hence this SOP will not serve its' primary purpose and therefore is not necessary.

Sincerely

Cynthia M. Allen, CMA
Financial Analyst
VoltDelta Resources

April 17, 1997

Mr. Daniel Noll
Technical Manager Accounting Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Via E Mail:
DNOLL@AICPA.ORG

Re: Accounting for Costs of Computer Software Developed or Obtained for Internal Use
File Reference No. 4262

Dear Mr. Noll:

Burlington Resources Inc. ("BR") has reviewed the Exposure Draft for the proposed Statement of Position Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and we are pleased to share our comments.

It is our position that the exposure draft adds an unnecessary burden to capture and/or allocate employee costs associated with capitalizing internally developed system costs. Additionally, we believe current accounting principles provide adequate guidance for companies to establish capitalization policies without issuance of a new accounting standard.

In our opinion, the costs associated with employees who work on developing software for internal use is a period cost and therefore should be expensed. Capitalizing these costs adds no value or incremental benefit to the company, shareholders or financial statement readers nor does it contribute to the understanding of financial statements.

Comparability issues, and there are many, should be addressed with disclosure to the financial statements. Therefore, we see no need for this exposure draft to be adopted as proposed.

Thank you for the opportunity to express our opinion on this issue.

Sincerely,

/s/ Curtis H. Threat
Curtis H. Threat
Director, Financial Reporting

BankAmerica

April 18, 1997

Paul R. Ogorzelec
Executive Vice President and
Financial Controller

Daniel Noll
Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Statement of Position
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

We are pleased to comment on the Exposure Draft of the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. We have limited our comments to the application of the proposed SOP to business enterprises. This letter does not address any concepts or issues related to not-for-profit entities.

We agree with the underlying premise of the proposed SOP, which is that the costs related to computer software developed or obtained for internal use be capitalized, and amortized over their estimated useful life in a systematic and rational manner. In general, we believe the SOP presents clear and concise criteria for identifying internal-use computer software costs, and provides practical accounting guidance. However, we believe the practical impact of implementing one of the provisions in the proposed SOP will impair the reliability of reported financial information. In particular, we do not support the capitalization of payroll and payroll-related costs for employees directly associated with internal-use computer software projects, as discussed below.

Capitalization of Payroll and Payroll-Related Costs for Employees Who are Directly Associated With and Who Devote Time to the Internal-Use Computer Software Project

We do not believe it is practically possible to capitalize payroll and payroll-related costs in a manner that will provide sufficiently reliable information to financial statement users. We believe that the methods companies must use to determine capitalized payroll and payroll-related costs are subjective, and will create an unacceptable level of diversity in practice. Conceptually, we do not believe that payroll costs incurred by the reporting entity are comparable to payroll costs incurred by a vendor and embedded in the vendor's price. Also, we believe that whatever benefits are achieved by capitalizing payroll and payroll-related costs will be short-lived, and be significantly outweighed by the costs of providing the information.

The Financial Accounting Standards Board's (FASB) has determined that in order to be useful, information must be representationally faithful, which is achieved by reporting information that is reliable and relevant, as defined in the FASB's *Statement of Concepts* (Concepts). Concepts defines reliable information as information reasonably free from error and bias, and representationally faithful. We believe the Concepts definition of "reliable" clearly applies to the reported costs of purchased software or consultant services, as evidenced by invoices from the outside vendor, but does not clearly apply to internally-determined capitalized costs.

Any system a company depends on to determine capitalized payroll and payroll-related costs will be based on subjective criteria, not on a fundamentally objective framework such as that provided by generally accepted accounting principles. BankAmerica Corporation will have to rely on management accounting systems that depend on multiple users' judgment regarding cost approximations and allocations. The risks associated with those judgments (e.g., the risks of misallocation) are acceptable within the reporting entity as a factor in determining how to deploy capital resources to maximize profit. However, we do not consider these risks acceptable for financial reporting purposes because they result in financial statement information that is not sufficiently reliable to be useful to decision makers outside the reporting entity.

In the absence of a practical method for objectively and uniformly determining capitalized payroll and payroll-related costs, we believe reporting entities will produce noncomparable financial statement information solely on the basis of adopting noncomparable methods for determining capitalized costs. This may foster a diversity in practice that the SOP is attempting to eliminate.

Paragraph 66 of the proposed SOP states that AcSEC believes it would be desirable for the costs of internally developed computer software to be no different than the capitalized costs of purchased software. Although we agree that comparability between the two costs is desirable for purposes of making capital allocation decisions (e.g., determining whether to build or buy), we do not believe comparability between the two costs is an appropriate standard for establishing financial accounting guidance because it does not promote representational faithfulness.

In particular, we do not consider the costs of computer software that includes capitalized payroll to be necessarily comparable to the cost of purchased computer software from an outside vendor. The price paid to an outside vendor may reflect many costs other than the vendor's payroll costs directly related to the software product, such as the vendor's overhead costs, or costs for research on and development of a wide variety of other successful and unsuccessful products. In addition, the vendor price usually reflects market competition for the product, market perception of diminished benefits (i.e. impairment) related to the product, the vendor's desired profit margin, and the vendor's production synergies. By contrast, the payroll costs included in internally-developed software will reflect the reporting entity's market competition for labor, employee benefits, and production efficiencies or inefficiencies.

Lastly, we do not consider the benefits of this provision of the SOP to outweigh the costs. Computer software is generally depreciated over a short term; therefore, we question whether capitalizing and amortizing payroll costs will create discernible benefits for financial statement users. We expect the costs of establishing and maintaining payroll records related to all internal-use computer software projects, including the allocation of payroll-related costs such as pension benefits and stock option rights, to be materially greater than the benefits of providing that information to outside users.

Response to Questions Posed in the Exposure Draft

The following additional comments and recommendations are in response to the questions asked in the exposure draft:

1. *Should the costs of computer software developed or obtained for internal use be recognized as assets?*

Yes.

Should entities have the option to capitalize or expense such costs?

No. We support consistency and comparability of financial information within and between industries.

Do the benefits of reporting those costs as assets exceed the costs of such reporting?

Generally no. However, as discussed above, we consider the capitalization of payroll and payroll-related costs directly related to internally-developed internal-use computer software costs to provide marginal benefits at a significant cost.

What are the costs of reporting?

The marginal costs of reporting generally include the costs of establishing and maintaining records of the assets, amortization schedules, and adequate internal controls over all reporting functions responsible for producing capitalized costs. In addition, the capitalization of payroll and payroll-related costs require separately maintaining and reconciling appropriate employee records, including time cards, pension and OPEB updates, payroll tax records and employee stock option records. Larger firms will have to establish and maintain project management systems that separately track direct project-related costs.

2. *Should the SOP specify that amortization should not exceed a maximum period?*

Yes. Although we conceptually believe the amortization period should be consistent with the benefit period, we are concerned that not establishing a maximum might lead to abuses or significant inconsistencies between reporting entities, within and between industries.

Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

No. We agree with the SOP that the method of amortization should be left to management's judgment, provided that whatever method is chosen matches the asset's benefit period in a systematic and rational manner.

3. *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?" If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment?*

Yes. We believe the SOP provides sufficient guidance for recognizing and measuring impairment during the development stages by including the rebuttable presumption that uncompleted software has a zero fair value. We believe this presumption effectively addresses the concern that firms would inappropriately defer costs related to unsuccessful internal-use computer software developments.

We believe the SOP generally provides sufficient guidance for recognizing and measuring impairment in accordance with SFAS No. 121 during the useful life of the completed asset. In those cases where we consider the guidance insufficient, we believe SFAS No. 121, not the SOP, is responsible. For example, SFAS No. 121 states that testing for impairment by comparing carrying cost to future cash flows will be applicable only at the entity level in some circumstances because no independent identifiable cash flows can be assigned to the asset being tested. Undoubtedly, some internal-use computer software products accounted for in accordance with the proposed SOP will fall into this hard-to-implement category. Nevertheless, since other long-lived assets are also subject to this provision of SFAS No. 121, we do not consider the accounting guidance in the SOP to be insufficient.

4. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?

No. We strongly support the SOP determination on this issue for the following reasons:

- We agree with the distinction made in the SOP's *Basis for Conclusions* between software developed for the marketplace, where technological feasibility is a prerequisite condition for marketability, and software developed for internal-use,
- BankAmerica Corporation has experienced significant difficulties applying the standard of "technical feasibility," and
- The costs incurred between the end of the "Preliminary Project Stage" and technological feasibility meet the conditions for capitalization as discussed throughout the "Capitalize or Expense" section of the SOP's *Basis for Conclusions*.

5. Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Generally no. However, for the reasons discussed above, we do not believe the SOP should allow the capitalization of payroll and payroll-related costs directly related to internally-developed internal-use computer software costs.

6. Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use?

Yes. Appendix A is clear and thorough.

Is the guidance appropriate? Why?

Yes. We consider the guidance appropriate because it is conceptually sound, and practical, uncomplicated and unambiguous.

7. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both?

Yes. We believe that this requirement eliminates any reporting ambiguity resulting from capitalizing computer costs at the "program instruction stage" under the SOP, and when "technological feasibility" is achieved under FASB Statement No. 86.

8. Is the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance operational?

Generally yes. However, we remain concerned that there may be differences in interpretation. We recommend creating an appendix similar to Appendix A which would provide examples differentiating between maintenance activities and capitalizable enhancements.

* * * * *

If you have any questions or comments, please contact me at (415) 624-1009, or Randy Shearer at (415) 624-0430.

Sincerely,

Paul R. Ogorzelec

cc: Mr. Michael E. O'Neill
Vice Chairman and
Chief Financial Officer
BankAmerica Corporation
555 California Street, 40th Floor
San Francisco, CA 94104

Mr. John J. Higgins
Group Executive Vice President
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Houston Chapter
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April 15, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The Houston Chapter of the Texas Society of Certified Public Accountants (The Chapter) is pleased to submit its selected comments concerning the exposure draft entitled Proposed Statement of Position-Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.

General Comments

The Chapter commends the Accounting Standards Executive Committee's (AcSEC) efforts to promote standardization and consistency in accounting for computer software. This is a positive step towards more complete recognition of intangible assets on the balance sheet. However, this Statement of Position (SOP) addresses only one very specific intangible asset. There are many others that should be considered in order to ensure that the objectives of consistency and completeness have been met. In fact, we suggest the Institute and other standard setting bodies should consider undertaking a more comprehensive review of the accounting for intangibles and proper reporting of these items on the balance sheet.

The Chapter is in general agreement that it may be appropriate to capitalize costs related to development or purchase of software for internal use. However, we are concerned that: 1) useful lives should be more clearly defined for purposes of amortization, and 2) the application of SFAS 121 may be difficult. Our specific comments on these two issues follow.

Amortization Period

Issue No. 2 asks if the SOP statement should specify a maximum amortization period. The Chapter believes the decision regarding the appropriate useful life should rest solely with management. However, if the SOP is silent on this issue, a specified maximum period may be necessary in order to ensure that an inappropriately short maximum useful life is not later imposed. A recognition of the SOP that major application software programs will many times have a very lengthy useful life could prevent the imposition of an inappropriate amortization period.

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President-elect: *Elwood M. Domaschk, Jr., CPA*
Vice President: *Deborah P. Touchy, CPA*
Secretary: *William F. Bisbee, CPA*
Treasurer: *John N. Messenger, CPA*
Treasurer-elect: *Elisabeth B. Castro, CPA*
Executive Director: *Nancy A. Rutledge*

There is no question that technology advances are so rapid and the never ending upgrades, new features and improved functionality are so appealing that current applications software quickly seems obsolete. In fact, the problem we face today in modifying current application software for the year 2000 is a direct result of this tendency to anticipate frequent software changes. The year 2000 problem exists today because so many developers of application software 15 or 20 years ago believed the programs they were developing would be obsolete by the year 2000. They could not imagine their code would be in use today, let alone in the year 2000. Now many businesses, as well as government agencies, find themselves with major application software programs that are more than 20 years old, all with this fatal flaw.

It would be helpful in implementing this standard to have AcSEC recognize and specifically designate a maximum useful life of 40 years. This is equivalent to the stated maximum amortization period for goodwill. Obviously, this long amortization period would not be appropriate for all software programs. However, for significant investments of millions of dollars in certain major application software programs, this acknowledgment in the SOP would lend credibility to estimates of long useful lives.

Some members of the Chapter believe that a 40 year maximum life would never be appropriate for computer software. An alternative suggestion would be to consider the useful life of the hardware as one factor to consider in determining the appropriate amortization period for the software.

In either case, in order to provide for some consistency, the Chapter believes more specific guidance is needed in the SOP for determination of appropriate useful lives for computer software.

Impairment

Issue No. 3 asks if the proposed SOP provides sufficient guidance for entities to recognize and measure impairment. The Chapter believes that the criteria for recognizing impairment is too broadly defined and will be very difficult to measure.

This standard includes, as one potential criterion for impairment, situations where the actual costs to develop the software significantly exceed the original estimates.

Applications software development costs have historically been very difficult to estimate. Most enterprises have experienced the frustration of preparing detailed economic evaluations in order to properly allocate resources to software development only to find the estimates pale by comparison to the actual development costs. This phenomenon seems to occur whether software is developed internally or externally. Therefore, there may be many instances when SFAS 121 will have to be considered.

The difficulty posed in applying SFAS 121 to measure impairment is that identifiable cash flows associated with the software will have to be calculated. Because most internally developed software applications do not have readily identifiable cash flows, many assumptions will need to be made in order to perform these calculations. It is unlikely that the objective of consistency the SOP is striving for will be met, due to the difficulty of applying SFAS 121 to these assets.

The result will likely be many diverse approaches due to the varied assumptions about market value, cash flows and original estimated cost. The Chapter would suggest in this regard that if SFAS 121 is to be applied, more specific guidance should be given to measurement of cash flows associated with the software. In the alternative, impairment should only be considered when the software is abandoned or the completed programs are not implemented.

The Chapter appreciates the opportunity to comment on the exposure draft. Should you have any questions regarding our response, please contact Ms. Kim Ousdahl at (713) 207-7434.

Very truly yours,

THE HOUSTON CHAPTER OF THE TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Steven R. Goodman
President

Kim Ousdahl
Accounting & Auditing Committee

ABBOTT

Abbott Laboratories
One Abbott Park Road
Abbott Park, Illinois 60064-3500

April 11, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262

Dear Sir:

We are pleased to respond to the Exposure Draft Proposed Statement of Position, "Accounting for Costs of Computer Software Developed or Obtained for Internal Use" (ED).

Abbott Laboratories is an $11 billion worldwide company engaged in the discovery, development, manufacture and sale of human health care products. Abbott's market capitalization is $45 billion with approximately 774 million shares outstanding. We are listed on the New York Stock Exchange.

The ED deals with only one of many "soft" assets which under current accounting standards are typically not capitalized. We believe that internally developed software, at least at the point of implementation, meets the definition of an asset. However, it, as well as many other soft assets, test the limits of measurability, recoverability, and reliability as the asset is consumed. We believe that additional study is required of the broad area of soft assets prior to selecting one of them for unique accounting.

In summary, we believe that the issue of capitalization of software costs should not be addressed prior to addressing the broader general issue of accounting for soft assets.

Very truly yours,

Frank J. Loughery
Assistant Corporate Controller

NYNEX
1095 Avenue of the Americas, New York, NY 10036
Tel 212 395 1047
Fax 212 597 2592

Mel Meskin
Vice President Financial Operations & Comptroller

NYNEX

April 16, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards, File 4262
American Institute Of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

NYNEX Corporation ("NYNEX") appreciates the opportunity to respond to your request for comments on the Exposure Draft entitled "Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" dated December 17, 1996 ("the proposed SOP"). NYNEX is committed to providing the AICPA with comments on proposed positions of accounting and welcomes the opportunity to participate in this process.

NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets. Our comments related to the specific questions posed in the Exposure Draft follow.

(1) Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

Recognition as assets
NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets.

While NYNEX recognizes that there might be current inconsistencies in practice as discussed in the proposed SOP, NYNEX believes that the capitalization of such costs will lead to further inconsistencies in practice because amortization periods will differ from company to company. The task of assigning a useful life to internal-use software will be difficult, if not impossible, due to the rapid changes in technology. Software that is put into use today may become obsolete within a year or two and/or may need to be upgraded with the purchase or development of new software. Due to upgrades and ever changing technology, systematic and rational allocation of internal-use software could prove to be unfeasible. The difficulty in ascertaining the appropriate useful life of software could also allow companies to assign unrealistically long amortization periods to the software thus leading to further inconsistencies in accounting.

NYNEX and other telecommunications companies incur substantial costs related to internal-use software. The predominate practice in the telecommunications industry is to expense the costs of internal-use software. In NYNEX's telecommunications network, the software is, on the average, replaced every 18 to 24 months through generic upgrades. If NYNEX were to capitalize such internal-use software and amortize it over a period of 18 to 24 months, the same level of expense as provided under an expensing policy would soon be reached. Thus, capitalization will provide little, if any, benefit to the readers of the financial statements and will increase the record keeping burden on companies, especially those in the Telecommunications industry.

NYNEX is also concerned that due to the rapid changes in technology, the proposed capitalization would require constant monitoring for impairment.

Lastly, at the time that SFAS No. 86 was issued, the FASB considered broadening the project to include costs incurred for internal-use software. SFAS No. 86 states in Appendix B, *Basis for Conclusion*, paragraph 26, "After evaluation, the Board concluded that accounting for the costs of software used internally is not currently a significant problem and, therefore, decided not to broaden the scope of this project nor add a project on internal-use software to its present agenda. The Board recognized that the majority of companies expense all costs of developing software for internal-use, and **the Board was not persuaded that this current predominant practice is improper**." NYNEX believes that even today the practice of expensing internal-use software is not improper due to the reasons stated above.

Option to capitalize or expense
NYNEX believes that entities should not have the option of expensing or capitalizing internal-use software costs. The primary goal of the proposed SOP, consistency, will not be accomplished if entities are allowed to have such an option.

Benefits vs. costs
NYNEX believes that the cost of reporting internal-use software costs as assets will be particularly burdensome and costly. NYNEX and other telecommunications companies expend hundreds of millions of dollars a year on internal-use software; therefore, attempting to track such assets would necessitate an exhaustive effort. At NYNEX, internal-use software typically serves different functions, e.g., switching, billing, payroll, etc., and, if capitalized, will require different economic lives and separate detailed tracking and amortization schedules. This will require additional personnel to track such data as well as enhanced computer systems to track the costs and to calculate the amortization expense. Lastly, as discussed above, NYNEX believes that, due to the rapid

changes in technology, the proposed capitalization of internal use software would require constant monitoring for impairment.

(2) The proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, NYNEX believes that if the proposed SOP is ultimately adopted, the SOP should specify that the amortization periods should be extraordinarily short, not to exceed 3 years, due to the rapid changes in technology. NYNEX believes the amortization method required should be the straight-line method so as to provide a more systematic and rational approach and consistency in use.

(3) Should impairment of internal-use software be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?* If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, NYNEX agrees with AcSEC that if the proposed SOP is ultimately adopted, the impairment of internal-use computer software should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* Internal-use software, if capitalized, will be a long-lived asset and, in order to provide consistency, should be covered by the provisions of SFAS No. 121. Otherwise, the issuance of any other guidance relating specifically to internal-use software would be confusing to preparers of financial statements.

(4) The proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing

the costs of computer software developed or obtained for internal use? If so, what are those criteria?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, if the proposed SOP is ultimately adopted, NYNEX agrees with AcSEC that the issue of technological feasibility should not apply to internal-use software for the reasons stated in paragraphs 44 to 49.

(5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, NYNEX believes that, if the proposed SOP is ultimately adopted, the kinds of costs that should be capitalized, as specified in Paragraph 26, is adequate.

(6) Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, NYNEX believes that, if the proposed SOP is ultimately adopted, the guidance provided to help entities determine whether computer software is for internal use is sufficient and appropriate. The proposed SOP alleviates the difficulty in determining whether computer software is for internal use and subject to the proposed SOP or "part of a product or process" and subject to FASB Statement No. 86. The SOP accomplishes this by providing both additional clarification of FASB Statement No. 86 and an appendix with specific examples of computer software that is and is not for internal use. However, entities still must use their judgment in determining whether or not a plan exists to market the software externally.

(7) Software is sometimes developed or obtained for both internal use and external marketing. The proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an

entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, if the proposed SOP is ultimately adopted, NYNEX agrees with the approach in the proposed SOP relative to this issue. It would be difficult to allocate costs between internal-use software and software to be marketed and then apply both the proposed SOP and FASB Statement No. 86. Consistency would then be lost because entities would use different bases for allocation.

(8) The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Although NYNEX does not support the provisions of the proposed SOP requiring that the costs of computer software developed or obtained for internal use be recognized as assets, if the proposed SOP is ultimately adopted, NYNEX believes the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance is operational and is practicable. However, NYNEX believes that subsequent enhancements and upgrades should not be capitalized due to the rapid changes in technology.

NYNEX thanks the AICPA for the opportunity to respond to the proposed SOP and welcomes any questions concerning the preceding comments.

Sincerely,

MACPA

April 14, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

On March 11, 1997, the Accounting Standards Committee of the Maryland Association of Certified Public Accountants met and discussed this proposed SOP. The following is a summary of the Committee's comments:

1. We believe that computer software developed or obtained for internal use meets the definition of an asset under FASB interpretation No. 6, and as such should be classified as an asset. If costs are material and enhance the functionality of the underlying asset, and the period of use exceeds one year, the costs should be capitalized. The benefits of reporting these costs do outweigh the costs of reporting them.

2. The SOP should not specify a maximum period of amortization. These costs are covered under other auspices, and combined with the rules of impairment, writing off the costs of the software is already prescribed.

3. We believe that the guidance detailed in FASB Statement No. 86 should be followed. Additionally, we believe that item (c) of the criteria in the SOP for determining whether to recognize impairment should be changed to discuss obsolescence with no significant upgrade.

4. We do not believe that an entity should meet a technological feasibility test, because if an asset meets the criteria in FASB 86, paragraph 103, it would mean that you would already have a completed project.

5. We are in agreement with paragraph 26 of this SOP concerning capitalizable costs. In this SOP the focus is narrower than FASB 86, but is not consistent with FASB 86 in practice. For instance, the indirect costs of programmers under FASB 86 are overhead costs. We as a committee, do strongly agree that FASB 86 should be clarified, similar to paragraph 26 in this SOP, with regards to overhead general and administrative costs, which are specifically mentioned in this SOP, but no direct mention is made in FASB 86.

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6. We feel that the guidance in the SOP is sufficient to help determine whether computer software is for internal use and that the guidance is appropriate.

7. We agree with the approach in the SOP that an entity follow either this proposed SOP or FASB 86. An entity should select one and consistently follow the method selected. However, we look to guidance when there is a change from internal use from external use software, for what can or cannot be capitalized. We feel that this should be stated in the SOP.

A final point that we, as a committee, feel should be addressed is that in the year that this SOP is employed there is no change in principal requirement showing the change in income (including dollar amount), as currently dictated by paragraphs 35-37. We feel that this should not be overlooked in the final draft of this SOP.

Respectfully submitted,

Paul J. Mantegna /c

Paul J. Mantegna, CPA
Sub-Committee Chair

James S. Schaefer /c

James S. Schaefer, CPA
Chair, Accounting Standards
Committee

KERR-McGEE CORPORATION
KERR-McGEE CENTER • OKLAHOMA CITY, OKLAHOMA 73125

April 15, 1997

DEBORAH A. KITCHENS
VICE PRESIDENT AND CONTROLLER

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File No. 4262

Dear Mr. Noll:

Kerr-McGee Corporation is pleased to have this opportunity to comment on the Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

We agree with AcSEC's conclusion that the costs of software for internal use should be recognized as an asset regardless if the software is purchased or developed. One would expect that material expenditures for internal use software imparts a long-term future economic benefit; therefore, capitalization of these costs should not be optional. We agree with AcSEC that it is not relevant whether the costs represent a tangible or an intangible asset. The reporting costs for these items should not be significant, except as noted below.

We generally agree with the capitalizable costs set forth in the proposed SOP. However, we do not agree with the capitalization of employee payroll and payroll-related costs from a practical standpoint. Such capitalization would require the use of sophisticated timekeeping systems that are not commonly utilized by most businesses. The benefits of capitalizing employee costs do not outweigh the costs of tracking employee time devoted directly to this type of project and relating that time to payroll and payroll-related costs. We also believe that, as with other acquisitions of major equipment, the costs required to get software ready for use should be capitalized rather than charged to expense as period costs. Some of these are either specifically addressed as period costs or are outside the scope of the proposed SOP. For example, initial training costs associated with newly developed or purchased software clearly represents a cost of getting the asset ready for use. Therefore, capitalization of initial training costs is appropriate, but ongoing training costs are properly charged to expense as period costs. In addition, some degree of data conversion is generally required for software to be fully functional. We view this data conversion as an integral part of most systems projects and as a cost of getting the asset ready for use. Accordingly, its cost should be included in the scope of the SOP as capitalizable.

In general, we agree with the capitalization period as set forth in the proposed SOP. However, if data conversion or similar activities have not been finished at the completion of testing, software is not ready for use. Additionally, consultants and contractors will often remain on site for some period after testing is complete to help insure a smooth transition to the new system. Therefore, the capitalization should not cease based solely on when the testing phase of the project is finished. The definition of when software is ready for its intended use should be revisited. We suggest that a project is complete and capitalization should cease when software applications have been installed, which includes all required data conversion and interfaces to other systems, and fully tested and are ready to be placed into service by the business users.

We agree that internal-use software represents a long-lived asset and therefore should be considered for impairment in accordance with FAS 121. However, software does not usually generate measurable cash flow. Therefore, the provisions of the statement are difficult to apply in cases where there is a remaining useful life at the time recoverability of the software's carrying value becomes questionable. For example, assume certain software that will not be fully depreciated until after the year 2000 is discovered not to be 2000 compliant. Without modification, the software will be useless before it is fully depreciated and has no market value. However, with the planned modifications that will be completed in 1999, the software will be useful beyond its present estimated life. Should the software be impaired at the time the year 2000 issue is determined, even though plans exist to correct the problem? How should the FAS 121 recoverability test be applied, and how should the impairment be measured? Illustrative examples of impairment issues in the final statement would be useful.

The distinction between enhancements and maintenance seems to be operational, but is in conflict with the consensus reached in Emerging Issues Task Force Issue No. 96-14. Software modifications for the year 2000 will most likely result in a significant extension of the software's useful life and may result in enhanced functionality, yet are to be expensed under the EITF consensus as are expenditures for routine maintenance under the proposed SOP. This disparity should be rectified before a final statement of position is issued.

We thank the Institute and AcSEC for considering our comments prior to issuing a final statement of position.

Sincerely,

Deborah A. Kitchens

Deborah A. Kitchens

The Gillette Company
World-Class Brands, Products, People

Prudential Tower Building
Boston, MA 02199-8004

April 15, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Dan:

We appreciate the opportunity to comment on the exposure draft of the proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. As you know through our prior conversations, we strongly agree with the recommendations proposed in the exposure draft, and recognize the effort required to develop the proposed statement.

As requested, I will give our response to the specific issues addressed in the comment letter.

1. Entities should not have an option to capitalize or expense costs which appropriately should be recognized as assets. However, as with any accounting standard, the usual materiality considerations should apply and that generally would preclude minor projects from being capitalized. Otherwise, the cost to administer the accounting systems necessary to account for minor projects may significantly exceed the benefits. Requiring that companies capitalize computer software costs utilized for internal use would encourage companies to improve the systems used to account for the development of these projects and this would provide several business benefits. Specifically, we believe that the utilization of such improved systems would improve project cost efficiencies and the internal accounting and administrative controls used to monitor such projects. This would also result in improved identification of the cost of developing software by application.

2. Our opinion is that the SOP should specify a maximum period for software amortization. We believe that software should be amortized over a period of at least five years on a straight-line basis. Guidance should be given to provide uniformity and any impairment should be duly recognized according to current GAAP guidelines.

3. As mentioned in point 2, impairment should be recognized and measured in accordance with the criteria of SFAS 121. The proposed SOP provides sufficient guidance regarding the issue of asset impairment.

4. We believe that the SOP criteria defining the capitalization of costs are adequate and that requirements for meeting any of the traditional accounting criteria associated with technological feasibility should not be necessary.

5. We believe that the proposed SOP capitalization criteria are appropriate with one exception. We would suggest that consideration be given to allowing for an allocation of indirect costs (primarily general overhead types of charges) which are specifically allocable to a capital project and which meet the allocation criteria specified in paragraphs 145, and 147 through 149 of the FASB Statement of Financial Accounting Concepts No. 6.

6. The SOP sufficiently provides the guidance to determine whether the software is for internal use. This guidance is appropriate.

7. These topic areas of the SOP are not applicable to us, therefore we have declined to comment on this issue area.

8. The guidance is fully operational as it is currently displayed in the SOP.

We are in favor of the proposed SOP, and we have highlighted certain minor points which we believe should be given further consideration. We advocate that you perform a speedy review of the comments and suggestions associated with the exposure draft and issue the SOP as the guidance, which is both appropriate and has been long-awaited.

I would gladly provide further information or comment.

Sincerely yours,

Albert S. DePiero

Albert S. DePiero
Manager, Accounting Research and Procedures

Comerica

Comerica Incorporated

April 16, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the America
New York, NY 10036-8775

Dear Mr. Noll:

Thank you for the opportunity to respond to the Proposed Statement of Position on "Accounting For Costs of Computer Software Developed or Obtained For Internal Use." Comerica is a $34 billion regional bank holding company located in Detroit, Michigan.

The SOP proposes to conform the diversity of current practice by requiring capitalization of internally developed software. The banking industry practice of expensing internally developed software derives from the difficulty of measuring the cost of developing the asset, determining a life over which to amortize the asset, and regularly assessing the asset for impairment. It is for these reasons that Comerica believes that required capitalization is inappropriate. We believe a better approach would be to allow for capitalization and require policy and capitalized software disclosures. Users can then assess the impact of capitalization on companies and determine comparability.

Answers to the specific questions in the SOP are as follows:

(1) See above.

(3) Impairment calculations using SFAS 121 imply that cash flows can be assigned to use of software. In the banking industry, much of the software supports products, often many products. While these products have discernable cash flows, the software itself does not generate cash flows. Impairment for banking software will need to be evaluated based on changes in expected life and usage levels.

(4) Technological feasibility is an important prerequisite to probable future benefit. However, trying to define the time of feasibility in other than broad parameters may be ineffective.

(5) Payroll and payroll related costs should be limited to direct costs, excluding costs "associated with" development.

Marvin J Elenbaas

Marvin J. Elenbaas
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USX

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Kenneth L. Matheny
Vice President & Comptroller

April 17, 1997

Mr. Daniel Noll
Technical Manager
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Noll:

Accounting Standards File Reference No. 4262

We have reviewed AcSEC's proposed Statement of Position (SOP) on **"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"** and appreciate the opportunity to offer comments for your consideration.

From a conceptual viewpoint, we agree with the majority of conclusions reached in the proposed SOP. We support the notion that software costs qualify as assets under the framework of generally accepted accounting principles. Related to the capitalized cost discussion is the issue of impairment. Issue No. 3 of the SOP asks the following question:

Q. Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*?

We do not believe that the SFAS 121 model is a good fit for capitalized software costs. SFAS 121 endorses an undiscounted cash flow approach to determining fair value. The determination of fair value for internal-use software cannot be reasonably viewed on the same modeling basis as hard assets used in the operations of an entity. Hard assets generate a series of cash flows over their economic useful life and as such can be subjected to the provisions established in SFAS 121. While we agree that recognition and measurement of impairment of capitalized software costs may be appropriate, it is difficult to put a fair value amount on software that is not marketable. The value of internal-use software is best measured by its ability to provide future economic benefit or service potential to an entity, as described in Concept Statement No. 6. For many manufacturing enterprises, software systems are usually an integral part of the operations. The concept of fair value should be determined by an enterprises continued use of the software package whether purchased outright and modified or internally developed. We support the need to impair capitalized software costs if there has been a loss in utility of the asset. The best indicator that the asset has utility is its continued use. We do not believe the fair value model prescribed in SFAS 121 is appropriate.

Mr. Daniel Noll
Page 2
April 17, 1997

In addition, we recommend that the final SOP provide guidance with respect to "unbundling" purchased software and hardware costs. The closest reference made within the SOP is in paragraph 9 on accounting for computer software when software consists of more than one component or module. We believe that unbundling software costs from hardware costs is appropriate when the useful lives of the software and hardware are different.

Thank you for your consideration.

Sincerely,

K L Matheny

Kenneth L. Matheny
Vice President & Comptroller

CC_AICPA.DOC

PHILLIPS PETROLEUM COMPANY
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CONTROLLERS

April 16, 1997

Mr. Daniel Noll
Technical Manager-Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

RE: **Accounting for the Costs of Computer Software Developed or Obtained for Internal Use** (File 4262)

Dear Mr. Noll:

In general, we agree with the guidance proposed by the Accounting Standards Executive Committee in the above-referenced Exposure Draft, including the basic conclusion that the significant, direct costs of developing and obtaining computer software should be capitalized as a long-lived asset.

Companies develop or obtain internal-use computer software for the same end-purposes that they develop or obtain other long-lived assets--to reduce costs, operate more efficiently, improve internal controls, service customers better and gain competitive advantages. The costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits and meet the recognition criteria of measurability, relevance and reliability. While some commentators may be concerned about capitalizing computer software due to its intangible nature and rapid pace of technological obsolescence, we believe that these concerns are not sufficient to prevent asset recognition. Computer software has all of the necessary conceptual characteristics of an asset, and is as identifiable and determinable as other common examples of intangible assets in the authoritative accounting literature (e.g., patents and goodwill).

Years ago, most major corporate computer software was developed by internal programming staffs in long-range, continuously-evolving projects. The ultimate success of such programming projects often was uncertain and the cost of such projects often was difficult to identify and segregate from on-going programming maintenance activities. Today, in contrast, most new major software is purchased from outside vendors, the products are already developed and have been demonstrated to be technologically feasible. Therefore, generally speaking, the uncertainty surrounding typical software projects is much lower today than in the past. As a result, we believe it is now time for the accounting profession to require consistent recognition of computer software as an asset when all of the other general characteristics for asset recognition are met.

We also agree with the proposed guidance on amortization, impairment, and distinguishing R&D activities.

However, we do object to the general prohibition against capitalizing any types of training costs. In paragraph 71, AcSEC states its belief that training costs should be expensed as they are incurred because entities are not able to identify the specific future period benefitted by the training and, thus, amortization periods would be arbitrary. We find this assertion unconvincing and unsubstantiated. Further, we find this assertion odd in view of the following statement by AcSEC in paragraph 58:

> "AcSEC recognizes that the specific future economic benefits related to the costs of computer software will sometimes be difficult to identify. However, AcSEC believes that this is also true for some other assets. For example, computer hardware or furniture used in back-office operations are indirectly related to future benefits. Likewise, the corporate office facilities do not result in indentifiable future benefits, but the facilities do support the operations of the company."

If, as noted in paragraph 58, AcSEC believes that the useful life of computer software is adequately determinable, then how can the useful life of related training costs not be just as determinable?

We believe that training costs incurred to "train the trainers" and to get a broad workforce up to speed on how to efficiently use a newly installed software product should be capitalized under the general rule in FASB Statement No. 34 that "the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use." Just like a new manufacturing facility, if there is not a critical mass of personnel adequately trained in the use of the new asset, then the asset is essentially worthless to the company. While many training efforts are relatively insignificant and thus can be expensed under a cost/benefit consideration, we do not believe that AcSEC should make a general prohibition against capitalizing training costs when such costs are significant and integral to the effective installation of an asset.

Sincerely,

PHILLIPS PETROLEUM COMPANY

Jacqueline K. Wagner

J. K. Wagner
Vice President and Controller

INVESTMENT COMPANY INSTITUTE

April 17, 1997

Mr. Daniel Noll
Technical Manager
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
File Reference No. 4262

Dear Mr. Noll:

The Investment Company Institute[1] appreciates the opportunity to express its views on the proposed statement of position relating to accounting for costs associated with internal use software (the "SOP"). If adopted, the SOP would require capitalization of certain costs incurred to develop or obtain internal use software. Under current practice, some companies capitalize these costs, while others expense them as incurred. Among companies that capitalize such costs, diversity exists over when to begin capitalization and what costs to capitalize. The SOP is intended to help eliminate the diversity in accounting for these costs and require recognition of costs incurred as an asset under certain circumstances.

While mutual funds and other investment companies do not directly incur the types of costs addressed by the SOP, their service providers (e.g., investment advisor, administrator, and shareholder servicing agent) may incur substantial costs associated with the development of internal use software. The investment advisor (which provides portfolio management services), the administrator (which provides portfolio accounting and trade settlement services), and the shareholder servicing agent (which provides transfer agent services) frequently develop customized internal use software to better enable them to serve the investment company and its shareholders.

While we appreciate the AICPA's objective of ensuring comparability in accounting for these costs, for the reasons set forth below, we believe that the proposed capitalization guidance is subjective and likely to result in inconsistencies in application. We recommend that issuers of financial statements retain the ability to expense costs associated with internal use software as incurred.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,309 open-end investment companies ("mutual funds"), 443 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.631 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

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Amount to be Capitalized

The SOP indicates that costs incurred subsequent to the research and development phase are to be capitalized. These costs are limited to: a) external direct costs of material and services, b) payroll-related costs for employees who devote time to the project, and c) associated interest costs. The amount of costs incurred to develop a particular software application will vary from company to company, depending on various factors including payroll rates, the skill and efficiency of programmers, and the company's interest costs. Accordingly, two different companies could incur (and capitalize) substantially different amounts for similar software applications. Further, these amounts may bear no relation to the amount at which a comparable software application could be purchased from an outside vendor.

Useful Life

The SOP requires that capitalized internal-use software be amortized over its estimated useful life. The SOP notes that entities should consider the effects of obsolescence, technology, competition, frequency of development changes and other economic factors on useful life. The guidance for determining useful life is very general and, consequently, a wide range of useful lives for similar applications will emerge. Accordingly, two different companies could incur (and capitalize) similar amounts for comparable software applications, but, because they applied different useful lives, they would report disparate asset and depreciation amounts.

Asset Impairment

The SOP provides that impairment would be recognized and measured in accordance with FASB Statement No. 121 *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.* Statement No. 121 requires companies to estimate future cash flows associated with an asset. If the sum of the future cash flows is less then the carrying amount of the asset, an impairment loss is recognized. Application of Statement No. 121 to internal use software would be very difficult since the software normally would not generate identifiable cash flows. We believe partial impairments would be rare and impairments would be recognized only when the software is abandoned.

Upgrades/Enhancements

The SOP indicates that costs of significant upgrades and enhancements to internal-use software should be capitalized if those expenditures will result in significant additional functionality *or a significant extension of the software's useful life.* Capitalization appears inconsistent with EITF Issue No. 96-14 pertaining to costs incurred when modifying software to be Year 2000 compliant. EITF Issue No. 96-14 requires these costs to be expensed as incurred (even though they are clearly necessary to extend the software application's useful life).

We believe the proposed standards for asset recognition, useful life, and impairment are so subjective that they will result in similar assets being recognized at differing amounts, reducing comparability in accounting for internal-use software. Issuers of financial statements should be able to elect expense or capital treatment based on their prior experience in developing similar internal use software applications. To enhance the understanding of financial statement users, we recommend that companies be required to disclose their relevant accounting policies and the amounts expensed or capitalized.

Very truly yours,

Gregory M. Smith

Gregory M. Smith
Director - Operations/
Compliance & Fund Accounting

State of Michigan
John Engler, Governor

Department of Consumer & Industry Services
Kathleen M. Wilbur, Director

Public Service Commission

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Commissioners

John G. Strand
John C. Shea
David A. Svanda

April 15, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

The Staff of the Michigan Public Service Commission (Staff) has reviewed the Exposure Draft and Statement of Position on "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," dated December 17, 1996. The Staff has also reviewed the accounting practices of several of the electric and gas utility companies under the jurisdiction of the Michigan PSC.

It appears that the text in the Exposure Draft reflects the accounting being practiced by the utility companies in Michigan. The Exposure Draft gives flexibility to the companies in the determination of the amortization period and the dollar amount to be capitalized or expensed. These are important features as the growth of competition and the restructuring of the energy industries continues. The Exposure Draft in its present form appears to be satisfactory.

Thank you for considering these comments.

Sincerely,

Hasso C. Bhatia, Director
Technical Services Division

Lee Irving
Executive Vice President
and Chief Accounting Officer

KeyCorp
127 Public Square
Cleveland, Ohio 44114-1306

Tel: (216) 689-3564

April 16,1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

We are writing in response to your invitation to comment on the Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (the "SOP").

KeyCorp ("Key"), headquartered in Cleveland, Ohio, is a bank-based financial services company that, at December 31, 1996, had assets in excess of $67 billion. Key has a network of approximately 1,200 banking offices across 15 states and offers a wide range of banking, fiduciary and other financial services to corporate, individual and institutional customers.

Key relies heavily on internal-use software to deliver products and services to its customers, and to provide administrative and operational support to its lines of business. In short, Key invests in internal-use projects to support and enhance revenue-generating activities. We believe internal-use software is a capital asset that should be accounted for like a long-lived asset. We have noted varying accounting treatments within the banking industry for internal-use software. There is a genuine need for definitive guidance in this area and we support the AICPA in its project. The following comments and suggestions are offered to strengthen the SOP.

Issue 1: Capitalize or Expense

We agree that costs associated with developing or purchasing internal-use software should be capitalized as assets whenever the costs clearly provide a future economic benefit. Further, we believe each internal-use software project can be found to have a determinable useful life; as such, capitalization and appropriate amortization allows the costs of development to be rationally allocated over (and matched to) the periods in which the benefits occur.

Allowing a choice of accounting treatments inevitably invites inappropriate comparisons among companies with differing optional treatments. In an ever more technologically-dependent information age, the cost of developing or purchasing internal-use software is likely to become an increasingly important competitive factor. For purposes of comparability and consistency, we do not believe that entities should have the option to either capitalize or expense such important costs.

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Issue 2: Amortization Period

We do not feel it appropriate to establish a maximum period for amortization. Such a maximum would necessarily be arbitrary and would presume that benefits do not accrue from the relevant costs beyond the maximum period in any single case. It is unlikely that anyone can presume to know what such an appropriate maximum would be. From our own experience, we know that many internal-use software projects are unique and are likely to have a variety of lengths of benefit periods. Key's policy is to estimate the useful life of each project separately. Although we also set a maximum amortization period (5 years) for any individual project, we believe that this is appropriately a matter of company specific policy as distinct from a generally applicable policy based on sound accounting theory. We believe practice in this area will develop and result in reasonable amortization periods without a maximum period arbitrarily assigned by accounting rules-makers such as the AICPA.

Issue 3: Impairment

We concur with the SOP's conclusion that impairment should be recognized and measured according to SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of,* which requires that capitalized costs in excess of the net present value of economic benefits produced by the asset be written off.

Due to the rapid evolution of software technology, companies will continually need to challenge their original estimates of useful lives of capitalized software and adjust amortization appropriately. Widely divergent impairment measurement techniques are likely to develop in the absence of more specific guidance from the AICPA. We believe the proposed SOP should provide additional guidance on impairment indicators. Evaluation of impairment is a complex issue; currently the SOP does not adequately address this topic and in our opinion offers a poor example for guidance. Paragraph 28 of the SOP suggests that the following is an indication of impairment: costs to develop or modify internal-use computer software significantly exceed the amount originally expected to develop or modify the software. We do not understand this specific example since an over-budget project does not necessarily imply impairment; it may imply an unrealistically low budget. If greater-than-expected costs can still be profitably recovered from the benefits derived from the costs, no impairment need exist.

We further recommend that there be additional guidance in the SOP on the measurement of fair value. Our experience has been that a discounted cash flow valuation methodology is often difficult to apply to specific software projects.

Issue 4: Pilot Projects and Technological Feasibility

Many in industry would disagree with the assertion that a "pilot program" is merely part of the initial research and development phase of a project. Key uses pilot programs in the testing stage of development and includes such costs with those which otherwise qualify for capitalization. We would recommend the AICPA consider altering the wording in paragraph 17 to clarify this issue. We agree that ultimately the software to result from a project's development costs, including those of a related pilot, must be technologically feasible to allow for capitalization of said costs.

Issue 5: Costs Qualifying for Capitalization

We believe the SOP is overly restrictive in the costs considered appropriate for capitalization. The AICPA should consider existing GAAP in its final evaluation. For example, we feel that training costs should be capitalized and not expensed. The provisions of SFAS No. 34, *Capitalization of Interest Costs* ("FAS 34"), states that the costs of acquiring an asset includes costs necessary to bring the asset to the condition necessary for its intended use. Training personnel is an integral part of implementing internal-use software; without training, the software would be useless. Further, SFAS No. 7, *Accounting and Reporting by Development Stage Enterprises*, includes the cost of training personnel as part of related capitalized assets.

We are also concerned with the provision of the SOP which requires general and administrative costs, as well as other overhead costs, to be expensed and not capitalized. Although these costs are period costs, they are directly related to the development of the software. We believe all direct costs of producing internal-use software, including general and administrative costs related to development of the software, should be capitalized. The proposed treatment would result in inconsistent accounting for such costs between purchased software and internal-use software. When an entity purchases software, the seller includes in the price a profit margin that is intended to cover both direct costs and the overhead incurred to support the development of the software. The SOP would result in capitalization of these costs for purchased software and expense of these costs for internal-use software. Furthermore, the FASB's question and answer guide, *Computer Software: Guidance on Applying Statement 86* states that, "Current accounting literature does offer precedent for capitalizing an allocated amount of indirect costs, such as overhead related to programmers and the facilities they occupy."

Issue 6: Upgrades or Maintenance

We recommend the SOP be written so as to be more explicit about the differences between upgrades and maintenance activities and to resolve a potential inconsistency between the SOP and current GAAP. Many companies are faced with implementing significant enhancements to application systems in order to deal with how the systems would use the year 2000 in calculations. The accounting for these so-called millennium projects was addressed by EITF 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000.* We believe under the SOP that the costs associated with millennium projects would meet the requirements for capitalization, (i.e., it is probable that the expenditures will result in a significant extension of the software's useful life), while EITF 96-14 requires the costs to be expensed. The final SOP should address this issue.

If you would like to discuss our comments in more detail, please feel free to contact me at (216) 689-3564 or Bill Schlag at (216) 689-4682.

Sincerely,

Lee Irving
Executive Vice President
& Chief Accounting Officer

Duke Power Company
422 South Church Street
Charlotte, NC 28242-0001

Jeffrey L. Boyer
Controller
(704)382-5227

DUKE POWER

April 16, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262

Dear Mr. Noll:

Duke Power Company (the Company) appreciates the opportunity to respond to the American Institute of Certified Public Accountant's (AICPA) proposed Statement of Position (SOP) on *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

The primary issue with the SOP is that it mandates capitalization of software development costs. In order to achieve consistency of practice, the more cautious option of expensing internal-use software development costs in the period incurred is eliminated and replaced it with a more 'liberal' policy requiring capitalization of a broad spectrum of charges including those associated with payroll and payroll related costs. This "cookbook" approach is unwarranted and directly at odds with conservative accounting practices.

In addition, the proposal mandate creates a number of other problems. First, companies may be forced to incur costs to track the development and related interest charges that are not justifiable. Second, the requirement to capitalize all internal-use projects may ultimately increase an entity's risk for impairments. Third, the AcSEC has inappropriately prescribed that capitalization begin at the completion of a set stage of development. The correct focus should be the point at which substantial costs have been incurred that will provide a probable future economic benefit. The SOP should be restructured to replace the stringent capitalization requirements with a more judgmental method that allows for the individual circumstances of an entity to be considered in capitalization decisions and permits the continued conservative practice of expensing software development costs in the period incurred.

The AcSEC is proposing that the SOP be effective for financial statements for fiscal years beginning after December 15, 1997, and that it should be applied to costs incurred in those fiscal years for all projects, including those in progress upon initial application of the standard. The result could be that costs for the same project could be expensed in one year and capitalized the next. If the final SOP indeed requires a change in capitalization practices, the SOP should grandfather projects in process.

If the AcSEC desires further clarification or discussion on any of the points presented herein, we will be glad to do so in whatever forum is appropriate.

Sincerely,

Jeffrey L. Boyer
Controller

Texas Instruments Incorporated

TEXAS INSTRUMENTS

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April 15, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position:
Accounting for the Costs of
Computer Software Developed or
Obtained for Internal Use
(File Ref. 4262)

Dear Mr. Noll:

Texas Instruments appreciates the opportunity to comment on this proposal. We agree that the costs of software developed or obtained for internal use should be capitalized. As noted, these costs meet the criteria of an asset under FASB Concepts Statement No. 6--a probable future benefit arising from a past transaction. The costs are specifically identifiable and have a determinate life. Our responses to other issues raised in the draft follow.

Issue: Should the document specify a method or maximum period of amortization?
Response: No, the APB No. 17 (Intangible Assets) approach of allowing alternative amortization methods has worked well and is valid in this case. Regarding a maximum life, we see no need for this. Individual considerations such as obsolescence and technology will dictate an appropriate life for these assets, as they do for fixed assets.

Issue: Should impairment be recognized in accordance with SFAS No. 121, the general impairment standard?
Response: Yes, that pronouncement provides reasonable guidance for calculating impairment for all long-lived assets, including internal-use software.

Issue: Should a "technological feasibility" criteria be required to be met before capitalization begins?
Response: No, this criteria, as used in SFAS No. 86 for software to be sold, is part of an inventory model for product to be marketed. The software under this proposal is to be used internally, not sold. Accordingly, capitalization standards should be consistent with other long-lived, internal-use assets, such as fixed assets, which do not use a "technological feasibility" criteria.

Issue: Is the proposed pronouncement too narrow in the kind of costs to capitalize?
Response: Yes, the proposed costs exclude allocated overhead on the basis of imprecision. This is illogical. Calculation of overhead is inherent in numerous internal accounting systems ranging from inventory costing procedures to the calculation of research and development costs. We are aware of no ongoing problems which have arisen in these areas and see no reason to exclude overhead in this case. As an aside, we note the proposal would require companies to estimate and exclude from capitalization maintenance and training costs imbedded in contract amounts. While we agree with this position, we see much more imprecision in this exercise than in the calculation of recurring overhead.

Issue: If the characteristics for internal use (i.e., solely for internal use; no plan to market) are not fully met, should the costs be accounted for under SFAS No. 86 as software to be sold? Or, should the costs be allocated between internal and external-use categories?
Response: As a practical matter, we favor the first alternative, i.e., that the characteristics should be fully met in order for the software to be classified as internal use. We are concerned the allocation method would require ongoing reevaluations and transfers from one category to the other--a likely cost-inefficient process.

* * * * * * * * * * * *

This concludes our comments. We would be pleased to discuss them further, if desired.

Sincerely,

William A. Aylesworth

William A. Aylesworth
Senior Vice President
Treasurer and
Chief Financial Officer

WAA/dc

Public Service Commission of Wisconsin

Cheryl L. Parrino, Chairman
Daniel J. Eastman, Commissioner
Joseph P. Mettner, Commissioner

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April 15, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Accounting Standards Executive Committee's Exposure Draft-*Proposed Statement of Position Regarding Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

Dear Mr. Noll:

The Public Service Commission of Wisconsin (PSCW) thanks the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants for the opportunity to comment on their *Proposed Statement of Position Regarding Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. The PSCW comments are enclosed.

Since telecommunications is one the most intense software driven industry and computer software is becoming more important in the gas and electric industries, we believe that accounting for computer software is an important issue. Due to the importance of the issue to the utility industry and the lack of consistency and direction regarding this issue, the PSCW welcomes this accounting Statement of Position.

If you have any questions regarding these comments, please contact Thomas Ferris, audit manager of our Telecommunications Division, at (608) 266-1124.

Sincerely,

Cheryl L. Parrino

Cheryl L. Parrino
Chairman

CLP:TJF:reb:h:\staff\tjf\software

Enclosure

cc: Thomas Ferris

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PROPOSED STATEMENT OF POSITION
REGARDING ACCOUNTING FOR THE COSTS OF
COMPUTER SOFTWARE DEVELOPED
OR OBTAINED FOR INTERNAL USE

COMMENTS BY
PUBLIC SERVICE COMMISSION OF WISCONSIN

The following are the comments of the Public Service Commission of Wisconsin (PSCW) in response to the exposure draft of a proposed *Statement of Position Regarding Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP), prepared by the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA). The comments are based on experience in the regulation of utilities (telecommunications, electric, and natural gas). Comments are organized by specific paragraph number as set forth in the SOP.

Preliminary Comments

In general, the PSCW supports the SOP and agrees with the staff of the Securities and Exchange Commission (SEC) and other interested parties that authoritative guidance is needed to help minimize the inconsistencies that currently exist in accounting for computer software used for internal purposes (paragraph 3). While the PSCW recognizes that the issue of capitalizing or expensing computer software becomes less important as we move to an environment of price regulation and eventually deregulation, we believe that the accounting principles of consistency and matching, as well as the importance of software to the operation of other fixed assets, support the need for guidance on the issue of accounting for computer software.

In the utility industry alone, consistency in accounting for computer software used for internal purposes does not exist. Electric and gas utilities normally capitalize computer software if a materiality threshold is met, similar to all other capital investments. In the telecommunications industry, initial operating software is capitalized, while operating software upgrades and application software are expensed by many large companies, but capitalized by some large companies and most smaller companies. The PSCW believes that there should be consistency within an industry as well as among industries.

In the telecommunications industry, the matching of revenues and expenses is an important issue related to accounting for computer software. In most cases computer software upgrades to the network contain new functional features. These features in turn allow the utility to generate new revenue sources in the future. If computer software is allowed to be expensed, there appears to be a violation of the accounting matching principle.

Notwithstanding the consistency and matching principles, computer software is a key component of the utility infrastructure, especially in the telecommunications industry. The PSCW supports accounting treatment consistent with Statement of Financial Accounting Standards No. 86 (SFAS 86), *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, where costs for computer software that is used as an integral part of a product or process are capitalized. In the utility industry, most software qualifies as an integral part of a company's infrastructure and should therefore be capitalized.

Paragraphs 11-12

Paragraph 11 of the SOP provides that internal-use software has two characteristics: (1) the software must solely meet the entity's internal needs, and (2) during development or modification, no plan shall exist to market the software externally. Paragraph 12 requires that an entity must meet both characteristics in paragraph 11 for software to be considered for internal use. In addition to these two paragraphs, Appendix A to the SOP provides examples of when computer software is and is not for internal use.

To the extent possible, the PSCW believes that the SOP provides sufficient guidance to help entities determine whether computer software is for internal use. One concern is the situation where an entity develops software for internal use with no plans to market the software, but subsequently determines that there is in fact a market for the software. In regulated industries this is especially a problem when an entity expenses the software costs and subsequently markets the software. In this situation, the customer pays for the costs of the software, but the revenues received are recorded as nonregulated and the customers do not receive the benefit from the sale to third parties. If the software is capitalized, this minimizes the problem as a result of paragraph 33. This paragraph specifies that any proceeds from the subsequent sale of the software be applied against the carrying amount of that software. If the software has been expensed, there is nothing to apply the proceeds against. Unfortunately, this situation may still occur if the software is amortized over a short period of time and the software is sold after the amortization period expires. Assuming that the amortization period properly represents the useful life of the software, an argument can be made that the customer has paid for and received the full benefit of the software. The PSCW is not sure how the proceeds from the subsequent sale of software will be treated if the software is expensed or if the amortization period is over.

Paragraph 19

Paragraph 19 states that computer software costs developed or acquired for internal use which are not research and development costs (paragraph 17) should be capitalized as a long-lived asset. According to the proposed SOP, the reasons given for not capitalizing internal-use software costs include: (1) such costs do not result in demonstrable probable future economic benefits (paragraph 53), (2) the period to which they relate is indeterminable or not worth the effort to determine (paragraph 54), and (3) capitalizing computer software costs frequently results in a subsequent write-off of those costs when they are eventually determined to not be recoverable (paragraph 55).

The PSCW supports the AcSEC's position in paragraph 56 of the proposed SOP that the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits, and meet the recognition criteria of definitions, measurability, relevance, and reliability. As such, the PSCW agrees with paragraph 19 of the SOP that, to the extent they are not research and development (R&D) costs as described in paragraph 17, the costs of internal-use computer software should be capitalized as a long-lived asset.

A capital expenditure is defined as:[1]

> An expenditure intended to benefit future periods, in contrast to a *revenue expenditure*, which benefits a current period; an addition to a capital asset. The term is generally restricted to expenditures that add fixed-asset units or that have the effect of increasing the capacity, efficiency, life span, or economy of operation of an existing *fixed asset.*

Computer software is definitely intended to benefit future periods similar to the hardware to which it relates. In the case of telecommunications utilities, internally-used computer software adds functionality that allows for new services and generates future revenues. While computer software may not in most cases directly increase the life span of a fixed asset, it does increase the capacity, efficiency, and economy of operation of an existing fixed asset. According to the above definition, therefore, computer software should be capitalized as a long-lived asset in accordance with this proposed SOP.

The PSCW also agrees with the AcSEC (paragraph 59) that while the costs of computer software developed or obtained may be subsequently written-off, this is also true for other long-lived asset projects. In addition, as the AcSEC points out, it has established guidance for when capitalization should cease and when impairment should be recognized and measured. For regulated utilities, it is unusual for computer software to be written-off prior to the end of the amortization period.

The PSCW also supports the AcSEC position and that stated in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, (paragraph 60) that an entity should not have the option to expense such computer software costs. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The telecommunications industry is a perfect example of the importance of comparability. As noted in our "Preliminary Comments," initial operating software is capitalized, while operating software upgrades and application software are expensed by many large companies, but capitalized by other large companies and most smaller companies.

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[1] Eric L. Kohler, "A Dictionary for Accountants", 6th ed., Prentice-Hall, Inc., Englewood Cliffs, NJ, 1993, cited by D.R. Carmichael, Steven B. Lilien, and Martin Mellman, "Accountants' Handbook", John Wiley and Sons, Inc., New York, NY, 1996, ch. 15, p. 9.

The PSCW agrees that the SOP provides a reasonable methodology to record and disclose the costs of internal-use software. The costs of reporting internal-use computer software as assets are no different than the costs of reporting other assets. The benefits of reporting and tracking the costs of internal-use computer software far outweigh the costs of reporting. The added costs of reporting internal-use computer software should be negligible since the accounting systems should already exist.

Finally, the PSCW believes that AcSEC (paragraph 65) should not provide practicable guidance to limit the amount of costs that could be capitalized to the amount an entity would spend to purchase a viable alternative software product from a third party. The problems noted by the AcSEC in the proposed SOP in identifying a comparable third-party product and incurring undue costs in trying to determine what is a viable alternative software product far exceed any benefits of limiting the amount of costs to be capitalized. The only time such a limitation might be appropriate would be if an entity was purchasing internal-use computer software from an affiliated entity. In this case, the purchasing entity may pay an above-market price due to the lack of an arm's length transaction.

Paragraph 24

Paragraph 24 defines upgrades and enhancements as improvements to existing internal-use software that extend the life or increase the utility of the software. According to paragraph 24, the costs of upgrades and enhancements should be capitalized if it is probable that those expenditures will result in significant additional functionality or a significant extension of the useful life of the software. Paragraph 24 defines additional functionality as changes to software that will allow it to perform tasks that it currently is unable to perform.

The PSCW agrees with the SOP's position regarding upgrades and enhancements. SFAS 86 defines product enhancements as improvements that are intended to extend the life or improve significantly the marketability of the original product. In the telecommunications industry the main purpose of software upgrades for switches is to add functionality to the switch in order to be able to provide advanced telecommunications services. The added functionality tends to extend the useful life of the switch since the utility will be able to utilize the switch longer before replacing due to the inability to provide new advanced services.

Concerns that we feel still need to be resolved are:

1. The SOP requires the capitalization of internally-used computer software upgrades and enhancements that are significant and which result in significant additional functionality or significant extension of the useful life of the software. Paragraph 63 states that, "Significant is used in the context to emphasize that routine activities are considered maintenance activities." The term routine is not defined. While there are general definitions in accounting literature for the terms significant and routine, the PSCW believes that additional definitions are needed in this SOP. While significant levels of enhancements can be defined according to current accounting literature, we are not sure what is meant by significant additional functionality. In the telecommunications industry, switch software upgrades are made every year, or normally no

more than every two or three years. If the upgrades are made every year, the issue of expense or capitalize would be moot. But if upgrades are routinely made every two or three years, should the upgrades be capitalized, or treated as maintenance activities and expensed? With the rapid changes in technology in the area of communications, there is a need for frequent upgrades that still would qualify as adding significant functionality.

2. Many times a major component of computer software is right-to-use fees. How should these fees be accounted for?

Paragraph 26

Paragraph 26 limits the costs to be capitalized to include only external direct costs of materials and services consumed in developing or obtaining internal-use computer software, directly related payroll and payroll-related costs, and interests costs incurred while developing internal-use software. Costs to be excluded according to the SOP include general and administrative costs, overhead costs, and training costs. For purposes of the SOP, the PSCW believes that the AcSEC's definition of the kinds of costs that should be capitalized in the measurement of internal-use software assets is adequate.

Paragraphs 30-31

Paragraphs 30 and 31 provide that the capitalized costs of internally-used computer software be amortized in a systematic and rational manner over the software's estimated useful life. In determining the estimated useful life, entities should consider obsolescence, technology, competition, other economic factors, and management's plans to replace any technologically obsolete software or hardware. According to paragraph 75, the AcSEC did not specify a maximum amortization period because each entity will be better able to determine an appropriate useful life.

The PSCW agrees with the AcSEC that each entity will be better able to determine an appropriate useful life for the amortization of internal-use computer software. Such periods will vary according to the specific type of software and the specific use of the software. In regard to software used for switching by telecommunications utilities, such amortization periods will more often than not be short due to changes in technology. Other software may have longer useful lives based on the specific use.

Other Issues

In addition to the above comments, the PSCW believes that there are two more issues that have not been addressed by the SOP. First, the Uniform System of Accounts (USOA) for telecommunications utilities, as prescribed by the Federal Communications Commission (FCC), contains the following provision for accounting for software:

> The original cost of initial operating system software for computers shall be classified to the same account as the associated hardware whether acquired separately or in conjunction with the associated hardware.

Under the FCC accounting, such software is depreciated over the longer useful lives of the associated hardware rather than over much shorter lives if the software is accounted for separately. Under the SOP, how should the useful life of initial operating software acquired separately or in conjunction with the associated hardware be determined? Should the software be depreciated with the hardware, or should it be depreciated separately?

A second issue relates to the accounting for software upgrades and enhancements. In some cases software upgrades replace initial operating software that is classified together with the associated hardware. In many of these cases, the software and hardware cannot be separately identified. If the software upgrade is capitalized as provided for in the SOP, the situation arises where the upgrade is being amortized at the same time as the replaced initial operating software is being depreciated. Does the proposed SOP cover this situation or does not the AcSEC believe that this is a problem?

<u>Conclusion</u>

In summary, the PSCW supports the proposed SOP. We believe that resolution of the concerns expressed throughout our comments will improve the final SOP. If you have any questions, please contact Thomas Ferris, audit manager of our Telecommunications Division at (608) 266-1124, by fax at (608) 266-3957, or by email at ferrit@mail.state.wi.us.

TJF:reb:h:\staff\tjf\softwaresopexposuredraft

General Mills, Inc.

One General Mills Blvd.
Minneapolis, MN 55426

April 17, 1997

Mr. Daniel Noll
Technical Manager Accounting Standards
File 4262 AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

RE: Proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"

After considering the proposed SOP, we are not aware of any significant benefit to financial statement users from the required capitalization of the costs of computer software developed or obtained for internal use. Consistent treatment of such costs among all entities would obviously be a benefit, if achievable. Even that goal is unlikely to be achieved, since determination of capitalizable costs and demarcation of the stages of software development (stage demarcation being critical to expensing or capitalizing) are subject to interpretation. Further we do not believe it is practicable to reliably and accurately identify and accumulate those internal development costs that will meet the capitalization criteria. Internally, software development is performed on a variety of projects, some of which will result in software which will provide future economic benefit and some of which will not. The costs of development and maintenance of an accurate separate cost accounting system to identify and accumulate all such internal software costs would seem to outweigh any perceived consistency benefit.

Expensing these costs is generally appropriate since demonstration that such costs provide probable future economic benefits is quite difficult, particularly in the current era of ever evolving and fast changing information systems, hardware and software that is available to entities. Determination of an appropriate life for such costs is also problematic. This is particularly true relative to internal costs to develop software systems that obviously have not been proven to be viable systems. On the other hand, software systems obtained from external sources have generally been proven to be viable systems prior to purchase. A practical and conservative rule might be to capitalize software development costs if a high probability of associated future economic benefits is apparent and there is a high probability of the determinate life being accurate (the high probability criteria). By default, costs not meeting the high probability criteria would be expensed as incurred. Generally costs to obtain software from external sources will be more likely to meet the high probability criteria. Some factors that may indicate when internal costs associated with software development (such as modifying externally purchased software or developing systems in-house) meet the high probability criteria include:

- management is viewing such development like a capital project (with budgeted costs, attendant approvals, etc.);
- significant costs are being committed to the project (particularly if the internal costs are incremental to the normal development costs, i.e. separate project team incremental to normal staffing levels);
- costs are being accumulated for tracking and management purposes relative to the budgeted project.

Therefore if the AICPA continues with this SOP project, we believe some type of high probability criteria should be added to allow for capitalization.

Thank you for the opportunity to comment on the proposed SOP.

Sincerely,

EGKroner

Edgar G. Kroner
Director of Financial Reporting

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Aerospace Industries Association

LeRoy J. Haugh
Vice President
Procurement and Finance
(202) 371-8520

April 17, 1997

Mr. Dan Noll
Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, New York
10036-8775

REF: Exposure Draft on "Accounting For the Costs of Computer Software Developed or Obtained For Internal Use"

Dear Mr. Noll:

The Aerospace Industries Association (AIA) appreciates the opportunity to respond to your exposure draft on "Accounting for the costs of computer software developed or obtained for internal use." AIA is a nonprofit trade association representing the nation's manufacturers of commercial, military, and business aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment.

Mandatory Capitalization Unnecessary

The exposure draft is placing "Form over Substance" rather than "Substance over Form." The AcSEC's reliance on FASB Concept Statement No. 2 (which states, "Comparability between enterprises and consistency in the application of methods over time increase the informational value of comparisons ...") as the basis for the mandatory capitalization of internal use software is misplaced for a variety of reasons. Additionally, without a prescription for the use of common methods and periods for amortization, any "comparability" gained by requiring capitalization will be self-defeating.

These costs do not need to be capitalized for the marketplace to determine the technological capabilities of entities when it establishes market values. The marketplace will establish values based on technological reputation and other factors, notwithstanding the values placed on internal use software in the balance sheets of companies operating in the marketplace.

Other comparable costs have different accounting treatments. As an example, acquired patents are usually capitalized but the costs of developing patents are usually expensed as incurred. Why would internally developed software have any more future value than the development of a patent?

Also, an entity's own internal labor and related benefits for developing in house software should never be capitalized. This labor would have been period overhead costs if not for the software project. Since overhead costs identified with the aforementioned internal labor are specifically excluded from allocation and capitalization in this new guidance, it is neither reasonable nor consistent to capitalize these otherwise period labor and benefit costs.

Uncertain Economic Benefit

The capitalization of these costs in such a rapidly changing, fast paced environment is not "conservative" accounting. Nowhere is the future economic benefit more uncertain and the potential for technological obsolescence more rapid than in the computer field. Software and computing technology is such a rapidly changing field that most equipment and software items quickly become obsolete. The software development industry is highly competitive and fast moving companies have developed software to meet specific requirements because no software had been available in the marketplace. It is not unusual for new and improved software to become available before the current application can be fully implemented. Consequently, by the time some internally developed software could be tested and implemented, a similar product could be available for sale at a fraction of the costs incurred internally. Further, commercial off the shelf (COTS) software packages become obsolete quickly and need to be updated. Most importantly, the cost of COTS software is merely a license to use the coded intelligence and does not typically represent ownership of an asset.

FASB Concept Statement No. 6 indicates that one of the characteristics of an asset is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits. Internal use software does not necessarily provide net cash inflows. The AcSEC's justification for this shortcoming is to compare this "intangible" asset to "tangible" assets such as computer hardware or furniture, both of which have some true resale market value. However, these internal use software costs, by definition and intent, do not have any resale market value.

Capitalizing these software costs can be compared to capitalizing Goodwill before any independent third party was willing to pay for the market value. APB Opinion 17, paragraph 24 states that "costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole -- such as goodwill -- should be deducted from income when incurred."

Clearly, internal use software has questionable value as a long-lived asset and requiring capitalization would be inconsistent with the accounting concepts reflected in FASB 121. Since internal use software is either developed specifically for, or modified extensively to fit, a business entity's specific circumstances, unlike other "long-lived assets," it is not likely to have any measurable market value. Thus, if capitalized, software would continuously have to be evaluated to determine if an impairment loss occurred and, unless there was some certainty of future business prospects, an immediate write-off would be necessary. To require capitalization with a high probability of immediate write-off due to impairment does not seem logical.

It is also difficult to measure future benefits with reasonable certainty and assign a meaningful life to these "long-lived assets." Costs should be expensed if they cannot be allocated systematically and rationally, or if doing so would serve no useful purpose.

Costs Outweigh Benefits

There is no empirical proof offered by the AcSEC that the benefits of this accounting policy outweigh the cost. Rather, we believe that the expense to set up a job cost system in order to comply with the proposed exposure draft outweighs the benefits to be gained by this very limited consistency for consistency's sake.

Additionally, we believe that it is difficult to differentiate between upgrades or enhancements and maintenance and they should all have the same accounting treatment. Once a software module is in place, further upgrades and enhancements should be expensed. Most maintenance costs are merely responding to system deficiencies or on-going changes and improvements to the supported business processes. Upgrades and enhancements are usually the result of accumulated process improvements that cannot be handled through the normal maintenance process. Trying to differentiate between the two would be difficult, potentially costly and non-value added because the same activity is being done, often simultaneously; only the degree is different.

However, having considered all the reasons for not capitalizing these costs, we recognize the need for flexibility in this highly subjective area. Significant software costs may be appropriately capitalized in certain circumstances. For instance, when the cost of the internal use software is well above normal software changes and the improvements required to run normal operations, such as a new major operating system, the costs could be capitalized.

The amount of costs capitalized could be limited to that which would be spent on a viable software product from a third party. The idea of capitalizing all the false starts and mistakes of a software project with no limit as to the amount capitalized does not follow conservatism and, thus, good accounting practice. Additionally, this limitless capitalization concept is inconsistent with FASB 121 requirements.

Summary

The AIA does not believe that it is sound accounting practice to require mandatory capitalization of software costs for internal use and strongly opposes this dictate in all cases. Flexibility is needed as to when these costs should be expensed versus capitalized. Materiality and a determination of market value should be required before a long-lived asset is recognized.

We have attached brief specific answers to most of the eight areas of questions identified in the exposure draft notice.

AIA wishes to thank you for the opportunity to comment on this important subject.

Sincerely,

LeRoy J. Haugh

LeRoy J. Haugh

Attachment to Letter on "Accounting For the Costs of Computer Software Developed or Obtained For Internal Use"

1. **Capital asset versus expense**
   Comments regarding capitalizing versus expensing are covered in the body of letter responding to the exposure draft.

2. **Methods and periods of amortization**
   If software costs are significant and warrant capitalization, there should be a mandatory maximum useful life. This maximum should be short, four years or less, since the length of the future economic benefit is uncertain and technological obsolescence potentially rapid. The amortization methods used should not be mandated. If mandated, we would favor a method that weighed heavily on depreciation expense being more in the early years such as double declining balance.

3. **FASB Statement 121, Impairment**
   When these costs must be capitalized, impairment should be recognized in accordance with FASB Statement 121. Additional guidance in this proposed SOP is not required.

4. **Criteria in order to capitalize**
   As stated in the body of our letter, costs capitalized should be limited to costs that would be spent on a similar viable software product from a third party, i.e. estimated market value.

5. **Kinds of costs capitalized**
   As stated in the body of our letter, costs capitalized should exclude an entity's own internal labor and related benefits.

6. **Sufficient guidance**
   The SOP contains sufficient guidance.

7. **Software developed for internal use and external marketing.**
   We agree with the approach of the SOP in using FASB 86. However, if this exposure draft is modified to include a limitation as to the amount to be capitalized, then this limitation should be used for the costs of software developed for internal use and external marketing.

8. **Upgrades or enhancements versus maintenance.**
   As stated in the body of our letter, the difference between upgrades or enhancements and maintenance is usually indistinguishable and just a matter of degree. Consequently, such costs should be treated consistently and be expensed.

Comments on Proposed Statement of Position (SOP) regarding the Accounting for the Costs of Computer Software Developed or Obtained for Internal Use dated December 17, 1996

These comments address the position of the Avionics & Communications Divisions of Rockwell International and do not necessarily reflect the same position as Rockwell.

We have read through and understand the contents of the Exposure Draft on the referenced subject. Our general impression is that the Accounting Standards Executive Committee (AcSec) of the American Institute of Certified Public Accountants (AICPA) desires to standardize the practice of treating internal-use software (hereafter referred to as software) as assets if they meet minimum cost and useful life thresholds. Some companies are already capitalizing software, while some (like ourselves) are not. Treating software like "long-lived" or tangible assets appear to be the general theme of the SOP.

We at Rockwell's Avionics & Communications Divisions support the thrust of the SOP and generally agree that internal use software should be treated in the same manner as tangible assets (assuming a minimum cost and useful life threshold). We may differ in opinion as we feel that the cost threshold for software assets be different from tangible assets. Our rationale is that there a significant amount of software purchased or developed by a large entity that would meet tangible asset capitalization criteria. These "new" assets would create additional cost to an entity that may outweigh the benefit gained by capitalizing the software. Each entity should be able to determine this threshold. This is consistent with the treatment of tangible assets.

Areas Requiring Particular Attention - Responses:

1) Should internal software, developed or obtained, be recognized as assets? We agree with AcSec's opinion that software be recognized as assets if it meets an entity's minimum cost and useful life thresholds. The useful life and minimum cost threshold should be policy determined by the entity and not legislated by FASB. If the minimum standards and the spirit of this draft are maintained, then entities should not have the option to capitalize or expense. This promotes consistent accounting policy -which we believe is the intent of the SOP.

2) Should the SOP define specific amortization periods and methods? We think the entity is in the best position to determine the estimated useful life of each qualified software asset and the depreciation method. This practice is consistent with the treatment of tangible assets.

3) Should impairment of software assets be recognized and measured in accordance with FASB Statement No. 121? We agree with AcSec's opinion and believe that the impairment should be subject to FASB No. 121 and guidelines outlined in the SOP are adequate to make this determination. This is consistent with treatment of tangible assets.

4) Should technological feasibility be considered a requirement before capitalizing a software asset? We agree that the feasibility criteria should not be applied to software assets, assuming these assets have cleared the "internal use" criteria and are not used in specific Research & Development projects. Feasibility studies are usually performed during the preliminary project stage. Therefore, software is usually not acquired or developed unless there is a reasonable expectation that it is feasible to use the software. This makes the feasibility requirement moot.

5) Is the SOP too broad or narrow in the kinds of cost that are capitalized as software assets? We are in agreement with the capitalized costs with one exception - overhead applied to internally developed software. It would be our desire to capitalize all overhead costs related to the application development organization. While capturing these costs for a small organization might not be practical, a definition broader that payroll and payroll related overhead needs to be considered.

6) Does the SOP provide sufficient guidelines for determining whether software is for internal use? In our opinion, the guidelines are sufficient. Most internally developed and purchased software is obtained with a purpose in mind (intent). The SOP makes it clear that the if the software goes into an end product, if it is used in the R&D phase of end product development, if it is intended to be a product itself or if it is intended be a component of product sold, the costs of the software are not capitalized. We think the paragraphs 13 and 14 of the SOP are well written and make it easy to evaluate the internal use criteria.

7) If software is developed or acquired to be both used internally and marketed externally, should the cost of the software be allocated between capital and expense? We agree with AcSec's conclusions that either the SOP or FASB Statement No. 86 should be applied, but not both. While it is probably appropriate to capitalize a portion of the software development or acquisition cost, it may not be practical to do so. It would be extremely difficult to determine an allocation scheme - leading to inconsistency.

8) Is the guidance regarding upgrade versus maintenance cost (the cost treatment thereof) useful? It is easy to determine whether costs are upgrade versus maintenance. We ask ourselves if the software's functionality is enhanced significantly or the useful life significantly extended. If the answer is yes to the functionality or useful life question, then the costs should be capitalized, If the answer is no, then the costs are maintenance and should be expensed. Paragraph 24 of the SOP is quite clear. We already make these judgments for tangible assets.

We appreciate the opportunity to comment and voice our opinions on the subject Statement of Position. If further discussion is desired, please contact me at your convenience.

Sincerely,

Patricia A. Nemeth
Director,Accounting
Rockwell/Avionic & Communications

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PANEMETH@CREMS.ROCKWELL.COM

Ford Motor Company

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April 22, 1997

Daniel Noll
Technical Manager, Accounting Standards
American institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Subject: Statement of Position (SOP) Exposure Draft, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (File 4262)

We appreciate the opportunity to comment on the subject Exposure Draft. Ford's long-standing accounting policy has been to expense the cost of software developed or obtained for internal use. This policy, which was reviewed and re-confirmed as recently as last year, is the result of two important considerations (discussed further below) that we believe have not been adequately recognized in the Exposure Draft.

Although it might be desirable to capitalize the costs of internal use software in an "ideal world", the practical issues involved with such a policy have repeatedly led Ford to conclude the most appropriate accounting treatment is to expense these costs.

- <u>Difficulty in Differentiating Between Enhancement and Maintenance</u> - It will be very difficult to formulate and communicate effectively consistent internal guidelines to differentiate between software development work that represents a significant upgrade or enhancement to be capitalized or maintenance to be expensed. In practice, changes to an application are often grouped together for efficiency in scheduling, resource utilization, and testing -- making this differentiation more difficult. For example, are several minor changes grouped together a significant upgrade? Is it logical that grouping expensed "maintenance" changes should end up being treated as a capitalized "enhancement"?

- <u>Difficulty in Defining Useful Life</u> - In the case of machinery and equipment, the useful life is determined primarily by when the asset "wears out", and the useful life is reasonably predictable. In the case of internal-use software, the useful life is much less predictable and often a function of factors unrelated to the software itself -- future software development resources, business priorities, and obsolescence of computer hardware usually determine when software is "renewed". In the current environment, any estimate of the useful life of software is likely to be little more than a guess.

- Project Cost Tracking System Required - Ford tracks its personnel and other costs on a departmental basis, not on a project basis. Development of a tracking system for costs by project would be required in order to accumulate the costs to be capitalized. Such a system would be costly to develop and maintain and would require interfaces that do not exist today with other accounting systems (such as payroll). We do not believe such an expense is justified.

For these reasons, Ford is opposed to any requirement to capitalize costs for internal-use software. We believe reporting entities should have the option to capitalize or expense such costs as they deem appropriate. If you would like to discuss our comments further, please feel free to call me at 313-337-8715.

Eric A. Law
Manager
Corporate Accounting and
Financial Reporting

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION
ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE
DEVELOPED OR OBTAINED FOR INTERNAL USE

Dated: December 17, 1996
Comment Date: April 17, 1997
No: 800108

****

April 22, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Response Prepared by: Accounting and Auditing Standards Committee
Society of Louisiana CPAs
Albert E. Roevens, Jr., Chairman
John D. Cameron
Judson J. McCann, Jr.

Response Submitted by: Judson J. McCann, Jr.

General Comments:

One member generally concurred with the draft with certain clarification.

Another member believes that the costs of computer software developed or obtained for future use should be expensed. In addition to the points discussed in paragraphs 54 and 55, the rapid technological developments often make the previous advancements obsolete well before they would be amortized. The member agrees with the conclusions of paragraphs 72-74 regarding the applicability of FASB 121.

Specific Paragraphs:

27 - One member believes a better wording for sentence three would be to end with the phrase "Based upon best estimates". This would incorporate paragraph 69. Without this added phrase, this paragraph is confusing to the reader.

24 - One member suggested the phrase significant upgrades and enhancements needs further explanation. It would be helpful to develop examples of what is considered "significant" upgrades and enhancements. Similar examples like those given in Appendix A would be of assistance in clarifying this point.

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA

30 and 31 - One member suggested if practices are to be less diverse and more consistent, some type of amortization life and method needs to be recommended. It was suggested that straight line amortization would not be appropriate with this type of asset, nor would an excessive useful life be appropriate given the constant changes in technology.

16 and 20 - One member did not necessarily agree when capitalization should occur as explained in paragraph 16 and 20. The "actual" cost to "develop" an asset may not be a true and accurate cost, if criteria two is followed in paragraph 20. Further clarification as to why criteria two is necessary before capitalization begins would be helpful.

Respectfully submitted on behalf of the Accounting and Auditing Standards Committee of the Society of Louisiana CPAs.

Yours very truly,

By____________________
Judson J. McCann, Jr.
Committee Member

JJMjr/jf

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B. K. Rawot
Vice President and
Controller

April 17, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File Reference No. 4262

Dear Sir:

We have reviewed the Exposure Draft (ED) of the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and appreciate this opportunity to present our views for your consideration.

Overall, we agree with the general direction of the SOP as well as its objective of improving financial reporting for what has become a significant unrecorded asset for many entities. We agree with the SOP's 'fixed asset-type model' for internal-use software accounting and believe that major internal-use software expenditures can create value beyond a single year and therefore costs should be capitalized and amortized over periods of expected benefit. A final SOP based on the ED, except as noted in the attached responses, will provide a reasonable methodology to record and disclose the costs of internal-use computer software.

We have responded to each of the eight issues of the SOP on the following pages. We would be pleased to discuss our comments further with you or your staff.

Sincerely,

B K Rawot

Billie K. Rawot

CC: S. Koski-Grafer - Financial Executives Institute

Attachment

1. *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

We believe that entities develop or obtain internal-use computer software for the same reason that they develop or obtain other long-lived assets, e.g., to operate more efficiently. As such, we believe that the costs of computer software developed or obtained for internal use meet the characteristics of an asset and should be recognized as assets. In addition, we believe that major internal-use software expenditures create value beyond a single year and therefore costs should be spread over the periods of expected benefit.

However, we believe that entities should continue to have the flexibility of either expensing or capitalizing internal-use computer software. Although the objective of the SOP is to develop guidance to help minimize the diversity of the accounting for the costs of computer software developed or obtained for internal use that currently exists, we believe that it is not necessary to eliminate all diversity in practice. This approach could be achieved by allowing the use of judgment with respect to determination of expense/capitalization thresholds. Disclosure of an entity's accounting policy should be required in the annual financial statements. If an entity elects to capitalize software, the SOP would provide the guidance regarding costs to be capitalized versus expensed.

2. *Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

We agree with AcSEC's decision to not specify a maximum period for amortization or a method of amortization in the SOP. We believe that each entity is best able to determine an appropriate useful life and method of amortization.

3. *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

We support the use of FASB Statement No. 121 in making determinations of impairment as this would be consistent with the recognition of impairment for other long-lived assets. Although we recognize that judgment will be required to determine the fair value of internal-use software for a cash flow analysis, we believe that FASB Statement No. 121 is a good framework to use.

4. *Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

We believe that early computer software project costs should be expensed. Once the computer software project is judged feasible (after completion of the preliminary project stage) and management commits to fund and complete the work, capitalization should begin. This will ensure that only costs that will provide a future benefit are capitalized. Capitalizing the costs of computer software developed or obtained for internal use prior to this point may result in a subsequent write-off of those costs when it is no longer probable that the computer software project will be completed and placed into service. We believe that users of financial statements may be misled by the initial capitalization and subsequent write-off of those costs.

5. *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

We believe that the SOP is too narrowly written in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. Other related internal support costs should also be capitalized if incurred incrementally to ongoing business activities including occupancy costs, PC support costs, data center costs, etc. Only truly unrelated costs such as corporate office expenses should be excluded. There is a potential inconsistency regarding the accounting treatment for such expenses which would be capitalizable when provided by external vendors (who will charge on a 'fully-loaded' basis), but expensed if incurred directly by the reporting entity.

6. *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?*

We believe that the SOP and the examples provided in Appendix A provide sufficiently clear guidance to help entities determine when computer software is and is not intended for internal use.

7. *Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

Consistent with the objective of the SOP to provide guidance for internal-use computer software and require continued application of the provisions of FASB Statement No. 86 for software to be marketed or sold, we agree that an entity should follow the guidance in either the SOP or the FASB Statement, but not both.

8. *Is the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance provided in the SOP operational?*

We agree with AcSEC's decision that the costs of significant upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures result in significant additional functionality. However, as with fixed assets, judgment will play a significant role in making allocations between upgrades or enhancements and maintenance.

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SALT RIVER PROJECT
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PHOENIX, AZ 85072-2025
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Mr. Daniel Noll
Technical Manager, Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

April 15, 1997

Re: Proposed Statement of Position
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll;

SRP is the nation's third largest public power utility, and as such we have had a fair amount of exposure to the development of internal use software. Before responding to the issues for which the AICPA has specifically requested comments, we would like to say that although we may not agree with all aspects of the proposed SOP that we appreciate the effort made by the AICPA on these issues. Internal software issues have needed clarification, and we applaud this effort. We would however like to see further clarification in the future of the accounting for costs of data conversion, which was an issue excluded from this project.

1) *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

We agree that, subject to a consistent application of a company's internal capitalization limits, and the meeting of certain requirements, as outlined in paragraph 20 of this proposed standard, it is proper to recognize these costs as assets, providing the costs do not represent research and development costs. Given consistent application of the foregoing items we do not believe that an entity should have an "option" of capitalization or expensing. Given reasonable capitalization limits the costs of reporting these assets should not be excessive, and at any rate should be able to be handled by a company's existing property and plant systems.

2) *This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify a maximum period? If so, why and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

We agree with the approach as proposed by this SOP. If significant, disclosure of the company's overall policy should be provided in the footnotes to the financials.

3) *Should impairment of internal-use software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?*

We agree that internal-use software assets should be subject to an impairment test, but we do not believe a calculation of expected future cash flows is generally relevant, and valuation of software developed only for internal use will often be difficult at best. The examples provided in paragraphs 28 and 29 should generally provide adequate guidance, but reference to FAS 121 unnecessarily complicates the issues. It would seem that in general it is quite apparent when an internal software component or module is impaired, and in absence of proof to the contrary, should be written down to a zero or adjusted book value when such a judgment can be made.

4) *This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB statement No. 86, Accounting for the Costs of Computer Software to be Sold Leased, or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

We agree with the approach taken in the SOP and do not believe that requirements to meet technological feasibility would be practical or cost-effective in the case of internal use software.

5) *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

We believe that the scope is too narrow. While we agree with the <u>included</u> list of items we also believe that it is appropriate to capitalize related General and Administrative costs. We do not agree with the assertion relating to allocated overhead made in paragraph 68 that "...measurements of the amounts that should be allocated to computer software are too imprecise." In our opinion such allocations are made routinely to other capital assets, and many companies have developed fairly sophisticated models to achieve these allocations.

In addition we do not entirely agree with paragraph 27, which specifies that training costs that are part of a purchase from a third party, should be expensed. We believe that the portion immediately following implementation should be capitalized. This should be fairly easy to identify, and many vendors would provide a separate estimate of such costs on request.

6) *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?*

Yes. The SOP's guidance is adequate. The criteria is clear and the examples in Appendix A clarify even further.

7) *Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all the characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

If an entity has a logical basis to allocate the costs between internal and external use it seems fair to allow a split in the accounting method, although to require such treatment may be a burden for those unable to make that judgment. There may also be differences in the amount of marketing planned. For example, a company's plans to sell the product to a very limited audience may be secondary, with internal use as the primary intent. In this sort of situation it may be somewhat burdensome for a company to be required to meet technological feasibility before capitalization begins.

8) *The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?*

Yes. The SOP provides adequate operational guidance in this matter.

Thank you for the opportunity to respond to this exposure draft.

Very truly yours,

Deborah L. Kimberly
Manager Finance and Administration

Randall Stephenson
Controller

SBC Communications Inc.
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San Antonio, Texas 78205
Phone 210 351-3030
Fax 210 351-3055

April 17, 1997

Mr. Daniel Noll
Technical Manager Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Fill Reference No. 4262

Dear Mr. Noll:

SBC Communications Inc. (SBC) respectfully submits comments on the Exposure Draft (Draft) of the proposed Statement of Position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (SOP). In general, SBC believes that software developed or obtained for internal use should be expensed as incurred. We believe this treatment would provide consistency in financial reporting and limit troublesome questions related to amortization periods, impairment and comparability between companies. The Draft requests comments on eight specific items. SBC's response on the eight items follows.

1) *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

   SBC does not believe the costs of computer software developed or obtained for internal use should be generally capitalized and recognized as an asset. We have consistently taken the position that initial operating system software is considered an integral component of the underlying hardware and is therefore capitalized as a part of that hardware. Subsequent operating system software and all application software is expensed in the period incurred.

   This policy is also the standard throughout the large, local exchange telecommunications industry. It is derived from Part 32 - Uniform System of Accounts for Telecommunications Companies, issued by the Federal Communications Commission (FCC).

   The Draft proposes capitalizing these costs using assumptions of future economic benefits that are much more relevant and logical for tangible assets than they are for software. We believe the future economic benefits associated with software are often tenuous and imprecise. This is particularly true in industries in which technological advances occur rapidly, and seemingly every change requires some revision to or replacement of the software. Studies in our industry indicate the average life span of major application software related to switching systems is between 18 and 36 months.

We believe there is little or no benefit to users of financial statements to capitalizing expenses with such a short life. It is also inconsistent with the accounting rules which require companies to expense research and development costs, advertising costs and costs associated with modifying computer software for the year 2000, all of which are very similar to internal use software.

The reporting and record-keeping costs associated with capitalizing software would include incorporating software into a property record-keeping (fixed asset) system, ongoing monitoring and analysis for asset impairment, ongoing reevaluation or revision of amortization periods, and, for the regulated telephone company industry, duplicate record-keeping for regulatory accounting and external reporting purposes since the FCC's accounting guidelines are different. We believe these costs would certainly outweigh any benefits derived from this accounting.

2) *Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

   The difficulty in selection of an appropriate amortization period is one of the reasons SBC is opposed to a policy of capitalization. In general, software will have a much shorter life than most tangible assets and the life of the hardware upon which it is installed will undoubtedly exceed the life of the software. The selection of an amortization period would be virtually arbitrary and would allow extensive latitude to manipulate earnings.

   Should software be capitalized, a maximum period for amortization should be established in the SOP. Based on our experience of short life spans for many significant applications, we recommend a maximum period of three years. A shorter maximum amortization period will correspondingly have the desired benefit of minimizing asset impairment issues. Straight line amortization should be used to minimize what would already be a confusing issue to financial statement users.

3) *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

FAS 121 has only recently been established as the authoritative guidance for measuring asset impairment. To suggest that FAS 121 may not be applicable and to note any difficulties with associating revenue streams with software applications only serves to reemphasize that internal use software is not an asset, but a current period expense.

4) *Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

SBC agrees that technological feasibility should not be a criterion used in determining whether to capitalize internal use software. Although we disagree with the proposal to capitalize internal use software costs, we do see a fundamental difference between internal use software and software to be marketed externally. It should not be difficult to distinguish between software used in research and development activities and software used in ongoing internal operations. This is especially true of purchased software.

5) *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

If software costs are to be capitalized, SBC believes that they should include the same costs, including overhead and supervisory costs, that any other self constructed asset would include. Again, suggesting that some of those costs would not be "appropriate" to include in a software asset is to suggest that there is something fundamentally different about internal use software and that it should not be capitalized.

6) *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?*

SBC believes the Draft provides sufficient guidance to help entities determine whether computer software is for internal use. The characteristics noted with respect to intent and functionality should be the principal considerations.

7) *Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

SBC agrees with the approach proposed in the Draft. Any indication or intent to market the software externally should require compliance with the provisions of SFAS 86 and not this SOP or a combination of both by attempting to allocate the costs to obtain or develop the underlying software.

8) *The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?*

SBC believes that distinguishing between costs that are upgrades or enhancements and costs that are maintenance is critical because maintenance costs, like training, are to be expensed. We do not believe the guidance in the Draft is sufficient. The guidance is too subjective. In practice, this will be a difficult distinction to make because of the way purchased software is priced and invoiced by software vendors. The distinction might be even more difficult for internally developed software because the boundaries between these activities are not easily drawn.

If you have any questions on the above comments, please call me on 210-351-3030 or Mr. Andrew E. Libera on 210-351-3043.

Sincerely,

Randall Stephenson

Randall Stephenson
Controller

Unocal Corporation
2141 Rosecrans Avenue
Suite 4000
El Segundo, California 90245
Telephone (310) 726-7646

UNOCAL 76

April 16, 1997

Charles S. McDowell
Vice President and
Comptroller

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

Unocal Corporation appreciates the opportunity to comment on the Accounting Standards Executive Committee's proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Although we are not fully convinced that there is a need for this SOP to be issued, we are generally in agreement with the guidance it provides.

In recent years, Unocal has had significant experience with software for internal use. We have replaced some large legacy accounting systems which were nearly 25 years old with new state-of-the-art systems. Because of the significant effort and costs involved coupled with the expectation that the new systems would be in use for a number of years, we elected to capitalize most of the costs. These costs are being amortized over periods ranging up to ten years depending on life expectations for individual systems.

One deviation we have from the guidance provided in the SOP is that we capitalize the cost of developing training and the direct costs of initial user training. We feel this is a necessary part of the effort to install a new system and the related cost should be capitalized. Another feature of our software accounting policy is that most PC software is expensed. More expensive purchased PC software which has a high expectation to be in use for several years is capitalized. Internally developed software is considered for capitalization if the cost exceeds an established threshold amount. This enables us to avoid the extra cost of tracking expenditures for fairly immaterial projects.

Responses to issues raised in the exposure draft are enclosed.

Again, we appreciate the opportunity to provide you with our comments. Good luck with your further work on this project.

Very truly yours,

Enclosure

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

Unocal Corporation's Comments on Issues Raised in the Exposure Draft

1. Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

Response - We believe the costs of computer software developed or obtained for internal use should be permitted to be capitalized. However, preparers of financial statements should have the option of determining whether or not this is appropriate handling in their situation. Capitalization makes sense for a firm which is likely to utilize the same software for a period of time spanning several years and where costs can be readily determined. However, for companies which change software frequently it may not be worthwhile to go to any extra effort or cost to capture and account for costs to be capitalized.

2. This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

Response - We do not believe there is any need for the SOP to specify a maximum amortization period or amortization method. We see no difference between capitalized software costs and other assets whose cost is amortized to expense and for which companies are free to determine the method and timing of amortization.

3. Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

Response - We believe FASB Statement No. 121 should be utilized in recognizing and measuring impairment of capitalized software costs. The proposed SOP provides sufficient guidance in this regard.

4. This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise*

Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

Response - Generally, from our perspective, we do not believe the SOP should include technological feasibility criteria. This type of criteria is less relevant for internal-use software where requirements and design tend to be much more focused that what might be expected for software designed for others.

5. Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Response - The proposed SOP is probable too narrow in the kinds of costs which should be capitalized. We feel the development of a training program and materials as well as initial user training should be capitalized. These types of costs are part of the cost of a new computer system and we see no problem with including them in capitalized costs.

6. Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

Response - The SOP adequately addresses this issue.

7. Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in this proposed SOP and some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either the proposed SOP of FASB Statement No. 86, but not both? If not, how should those costs be allocated?

Response - We believe the SOP has taken a reasonable approach in dealing with the issue of software being developed for dual purposes.

8. The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Response - We agree with the guidance regarding upgrades or enhancements and maintenance and we believe the definitions of these terms are operational.

April 16, 1997

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Fax 410 716 3879

Vice President and Controller

BLACK&DECKER®

April 23, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: File 4262

Dear Mr. Noll:

The Black & Decker Corporation appreciates the opportunity to comment on the Exposure Draft of the proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (ED).

Our observations on the issues for which specific comments were requested are summarized in Attachment I to this letter. However, we have several fundamental issues with the project which we wish to express prior to commenting on those specific items.

Foremost is our concern that the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) is particularly ill-suited to be establishing generally accepted accounting standards (GAAP) for this subject. While not in any way intending to impugn the integrity of any of the individual task force members, it seems to us that the AICPA, as the trade organization for the "Big 6" accounting firms, some of whom are the largest providers of system integration services, has the appearance of a conflict in interest with respect to this issue. In our view, such an independence issue, whether real or perceived, undermines the credibility of the standard. We do not believe that the Financial Accounting Standards Board's (FASB) clearing process is a sufficient mitigating factor.

Secondly, this ED represents the continuation of a disturbing trend in the scope of AICPA projects toward general issues, following in the footsteps of Statements of Position on the topics of risks and uncertainties and environmental liabilities. While a case could be made that the AICPA has a valuable role in the standard setting process by providing guidance on applying GAAP to industry specific circumstances, we believe that the creation of general purpose GAAP is best left to the FASB and, for registrants, the Securities and Exchange Commission.

In addition to our concerns regarding AcSEC involvement, we believe that the scope of this project, by excluding the related re-engineering efforts surrounding many such projects, is inappropriate. The value created by the investment in systems in terms of incremental cash flows or cost avoidance, on which the basis for capitalization accounting is predicated, results

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in many cases from the re-engineering occurring on the periphery of the project and not from the system itself. By basing the accounting on natural expense classifications rather than broader business processes, we feel that the accounting will become divorced from the economics of the investment and thereby reduce the effectiveness of financial reporting rather than improve it.

Alternatively, we believe that the accounting for systems projects should be evaluated by their objective rather than the nature of the expense. We have included as Attachment II an outline of a model that groups systems projects into three categories by the nature of the project, the accounting for which should differ. We believe that such a model would more accurately align the accounting with the economic consequences of management's actions and the capital investment process.

Notwithstanding the comments made in the Introduction and Background section of the ED, we remain perplexed as to exactly what financial reporting problem the ED proposes to correct. While not experts in this area, we are not aware of any financial reporting disasters that revolved around entities not capitalizing acquired or internally developed software for internal use. Also, while acknowledging that there may be diversity in practice as alluded to above, we believe that the standard setters would be well served by attempting to determine whether that diversity has a rational economic basis before seeking to eliminate it.

With respect to the conclusions reached in the ED, we would be remiss in not emphasizing our vehement disagreement with the requirement that certain internal costs be capitalized. Such a requirement would likely require investment in project tracking software and time and attendance or job cost systems for exempt workforces in order to appropriately control and document the asset being created, not to mention the incremental administrative effort associated with collecting that information. We strongly suggest that AcSEC demonstrate and quantify the benefit from the improved financial reporting associated with that cost before forcing reporting entities to incur that cost. Since we believe that the financial reporting benefit is nil, we are skeptical that such an analysis would lead to the conclusion that mandatory capitalization is cost justified. We again suspect that most system investment decisions are based simply on the incremental cost to the entity rather than including an allocation of fixed costs.

In summary, we believe that AcSEC is not the appropriate entity to address this issue due to the potential for an appearance of a conflict of interest as well as the general nature of the standard. Additionally, should the FASB feel the necessity to take up the issue, even in the absence of compelling need, we believe that the scope of the project is inappropriate and does not result in improved financial reporting and, accordingly, should be thoroughly re-examined.

Very truly yours,

Stephen F. Reeves

SFR279/sk

Attachments 2

Copy: Director of Research and Technical Activities
Financial Accounting Standards Board

ATTACHMENT I

Areas Requiring Particular Attention

(1) As indicated in the body of our letter for the reasons set forth we strongly disagree with the mandatory capitalization of internal costs. Additionally, as alluded to in the letter we believe that there are rational economic reasons why their is diversity in practice which should be accommodated by any standard issued on the topic. See ATTACHMENT II for our recommendations.

(2) The selection of arbitrary maximum lives would be of no particular value. The concept of estimated useful lives has not been too difficult to apply in any other circumstance.

(3) If we were to accept that the accounting model selected was appropriate, which we do not, then the use of FASB 121 methodology to determine and quantify impairment would be appropriate.

(4) As noted in the body of our letter we believe that the accounting model selected is flawed in not recognizing inherent differences in different types of system investments. Technological feasibility is largely assumed in the investment of well-known packaged software. However, when software is custom developed to provide a competitive edge technological feasibility is not assured but is important to the determination of whether an asset has been created. We believe that technological feasibility should be a prerequisite for capitalization.

(5) As noted in our letter and Attachment II we believe that the ED is too narrow in its scope. Costs to modify business processes around the functionality of the software are material to the creation of value from the system investment and accordingly should be addressed in conjunction with the costs included in the ED. Absent these costs it is not clear that all of the conceptual criteria for asset recognition have been met.

Secondly, while we do not agree with the concept of mandatory capitalization of internal costs, if such costs are required to be capitalized to be conceptually sound they should be the fully burdened internal costs including allocable overheads and training. The notion that it is too imprecise to determine the amount to capitalize is, frankly, not believable in light of the efforts made to determine the fully burdened costs to manufacture product. Additionally, the investment in training to make the investment functional would not seem separable from the investment itself.

(6) We believe that the guidance provided is adequate.

(7) We agree with the guidance provided.

(8) The guidance provided is satisfactory.

ATTACHMENT II

While we are not convinced that there is a need for change in current accounting, the following is an alternative to the natural expense accounting model proposed in the ED.

We believe that new systems investments can be grouped into three broad categories: investment which provides an incremental revenue stream or enables the sale of a new product or service, one which provides additional functionality which enables cost reduction and one which replicates existing functionality on new infrastructure. The accounting for the different types of investment would vary reflecting the differing risks and opportunities associated with the investments.

The first category would represent systems that provide a competitive edge and generate incremental revenues. Generally related to service providers, such projects would, by their definition, almost preclude packaged software solutions and would typically be internally developed or contacted out to specifications. The capital appropriation criteria would generally be similar to new product development with the investment decision based on the probability of a new revenue stream and related competitive response.

For investments of this nature we believe that the appropriate accounting model is FASB Statement No. 86 ("FAS 86") as we do not see a significant distinction between revenues generated from the sale of the software to the end user or revenues generated by the use of the software by the company for the benefit of customers. In this instance, technological feasibility is an important issue, and impairment can and should be measured based on the FAS 86 criteria.

A second category would represent system implementation for improved functionality in order to improve operational efficiency. These projects often have large process re-engineering efforts associated with them which is where the real value is derived. The capital appropriate decision would be based on the reduced operating costs, improved service levels or reduced working capital investment derived from the process re-engineering. In this instance, capitalizing only the system component of the costs makes no rational economic sense.

For this type of project, the fixed asset model outlined in the ED is in our view reasonable. However, as indicated above we believe that if the current scope were retained and re-engineering costs excluded, the resulting accounting would be more misleading than informative. Because the costs related to management's investment decision would be recognized arbitrarily under the ED and not match the associated benefits, it would be difficult for both management and investors to judge the efficacy of the investment decision. The FAS 121 impairment criteria would appear to be logically applied to this fact pattern.

Last is that class of project which is usually information systems driven, where a new system is intended to substantially replicate existing functionality on a more modern infrastructure. The investment decision in this case would be similar to that for functional capital, predicated on the avoidance of failure. The use of the fixed asset model would seem inappropriate and would also appear to contradict the recent conclusions of the EITF on the change in millennium costs. Expense as incurred seems to be the most appropriate accounting in this circumstance.

Carlos R. Mello
Senior Vice President
Comptroller

people's bank

People's Bank
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April 23, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
Accounting Standards Executive Committee
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

People's Bank is pleased to comment on the exposure draft of the proposed Statement of Position ("SOP") *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

Overall, we concur that authoritative guidance should be developed to help minimize the inconsistencies that currently exist regarding the treatment of costs associated with computer software developed or obtained for internal use. AcSEC has utilized an extension of existing standards as a basis for the guidelines and conclusions developed in the proposed SOP, and we believe that their conclusions are defendable and appropriate under existing literature.

We support AcSEC's position that the costs of computer software that is developed or obtained for internal use should be recognized as assets if (1) the costs incurred are expected to provide future economic benefits and (2) if such costs are considered material. The decision to capitalize or expense should be made using guidelines created, however, the ultimate decision as to whether or not certain types of costs meet the criteria for capitalization should be based on a "facts and circumstances" basis and left to the judgment of the preparers of financial statements. This is discussed further in our response to Issue #1.

In addition, we believe that the lives of these assets would be relatively short due to technological changes . AcSEC should allow each entity to determine the appropriate useful lives of the assets. Further, we suggest that the amortization of software costs should begin when capitalization ceases and when the software is placed in service, as opposed to when the software is considered to be ready for its intended use as suggested in this proposed SOP. Refer to our response to Issue #2 for discussion on this topic.

Our responses to the eight specific issues addressed in the exposure draft of the proposed SOP are enclosed. We thank AcSEC for the opportunity to comment on the proposal and for their consideration of the concerns and recommendations raised in our responses. Please contact Lori Esposito (203)338-4064 or myself (203)338-4071 if you have any further questions.

Sincerely,

Carlos R. Mello

Carlos R. Mello

CRM/mb

<u>Issue #1</u>: *Should the costs of computer software developed or obtained for internal use be recognized as assets?*

The costs of computer software that is developed or obtained for internal use should be recognized as assets. Such costs meet the three essential characteristics of an assets, as outlined in paragraph 26 of FASB Concepts Statement No. 6. We concur with guidelines in the proposed SOP related to materiality and the ability to demonstrate probable future economic benefits as criteria for capitalization of these costs.

Should entities have the option to capitalize or expense such costs?

Entities should capitalize *certain* costs based on facts and circumstances. In some instances, the cost of converting data from an old system to a new system and the cost of reengineering operations could be considered costs associated with research and development of software and would therefore be expensed as incurred. In other circumstances such costs may be considered critical to the design of a chosen path or to testing performed during the program instruction stage and should be capitalized. AcSEC should allow preparers of financial statements and their external auditors to use their judgment to decide whether or not to capitalize such costs based on the surrounding facts and circumstances.

Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting? Paragraphs 50-67 provide the basis for AcSEC's conclusions.

The costs of reporting deal with an entity's ability to track and allocate payroll and related expenses of individuals involved in the program instruction and implementation stages of software purchased or developed for internal use. Such costs could be significant. If these costs are deemed to be immaterial, entities should be allowed to continue to capitalize direct acquisition costs and expense immaterial payroll related costs. In such instances, materiality should be the basis used to determine the capitalization policy to be followed.

<u>Issue #2</u>: *This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified?*

The SOP should not specify a maximum period for amortization. Existing guidelines set forth in ARB 43 and APB 17 and the impairment standards under SFAS 121 are considered adequate, and we agree that each entity would be able to determine the appropriate useful lives of assets.

Should the SOP require certain methods of amortization? If so why, and what methods should be required? Paragraph 75 provides the basis for AcSEC's conclusions.

We believe that a straight-line method of amortization should be applied unless an entity demonstrates that another systematic method is more appropriate, in accordance with paragraph 30 of APB 17.

In addition, Chapter 9, Section C, paragraph 5 of ARB 43 dealing with depreciation of assets states that "GAAP requires that costs be spread over the expected useful life of the asset in such a way as to allocate them as equitably as possible to the periods during which services are obtained from the use of the asset." The amortization of software costs should begin, therefore, when capitalization ceases and when the software is <u>placed in service</u>, as opposed to when the software is considered to be ready for its intended use as suggested in this proposed SOP. Some amount of time could elapse between the time software is considered to be ready for its intended use and when it is actually placed in service. The matching principle as defined in FASB Statement of Concepts No. 5 suggests that the date when the asset is placed in service is the appropriate date to begin amortizing costs capitalized. Results reported in a given period could be significantly different if software costs are amortized beginning when software is considered to be ready for its intended use vs. when it is placed in service depending on time elapsed between the two dates and the useful life assigned to such assets.

<u>Issue #3</u>: *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets? Paragraphs 72-74 provide the basis for AcSEC's conclusions.*

SFAS 121 provides sufficient guidance for entities to recognize and measure impairment.

Issue #4: *This proposed SOP required capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria? Paragraphs 44-49 provide the basis for AcSEC's conclusions.*

We concur with and support AcSEC's conclusions set forth in paragraphs 44-49.

Issue #5: *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded? Paragraph 68 provides the basis for AcSEC's conclusions.*

We believe that the scope of the proposed SOP is too narrow in the kinds of costs that should be capitalized. We agree that direct costs and payroll related costs incurred should be capitalized. We further agree with AcSEC in using SOP 93-7 and SFAS 91 as a basis for determining types of costs to be capitalized. However, AcSEC should allow entities some flexibility in applying guidelines and determining whether or not such costs are to be capitalized based on the surrounding facts and circumstances, as stated in our response to Issue #1.

Issue #6: *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why? Paragraphs 38-43 provide the basis for AcSEC's conclusions.*

We believe that the guidance provided under the proposed SOP as well as the examples provided in Appendix A are sufficient. The provisions of SFAS 86 should apply if an entity plans to market software externally. Allocating costs between internal use software and software to be marketed is considered impractical.

<u>Issue #7</u>: *Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated? Paragraphs 38-43 provide the basis for AcSEC's conclusions.*

We agree with the approach in this proposed SOP that requires an entity to follow the guidance provided that all characteristics for determining whether computer software is for internal use (as discussed in Paragraphs 38-43) are met. If not, an entity should be required to account for such costs under SFAS 86. As stated in our response to Issue #6, we agree that allocating costs between internal use software and software to be marketed is considered impractical.

<u>Issue #8</u>: *The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational? Paragraphs 63-64 provide the basis for AcSEC's conclusions..*

Yes, the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance is operational. We concur with AcSEC's use of existing standards and guidelines as a basis for making such determinations as provided in SFAS 86.

Adrian J. Donoghue
Vice President
& Controller

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NORTEL
NORTHERN TELECOM

April 16, 1997

Accounting Standards Executive Committee
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York
10036-8775

Attention: Daniel Noll, Manager Accounting Standards
File #4262

Dear Sir:

Pursuant to the American Institute of Certified Public Accountants' (AICPA) recently issued proposed statement of position regarding "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use", I would like to take this opportunity to respond on behalf of Northern Telecom Limited ("Nortel"). While we strongly support the evolution and betterment of accounting standards, this particular proposal does not appear to contribute to achievement of the goal of producing financial statements that improve the resource allocation decision-making abilities of the users.

BACKGROUND INFORMATION

Nortel operates in one business segment, telecommunications equipment, which consists of the research and the design, development, manufacture, marketing, sale, financing, and support of telecommunications products and services. Nortel had 1996 revenues of U.S. $12.8 billion and has approximately 62,000 employees worldwide.

Nortel is traded on the New York Stock Exchange in addition to the Toronto, Montreal and Vancouver stock exchanges and as a result we seriously consider Securities & Exchange Commission (SEC) reporting requirements.

NORTEL'S PERSPECTIVE

We recognize that the proposed statement of position was developed in an attempt to reduce the inconsistencies that exist between reporting entities with respect to accounting for internal use software costs. The current absence of accounting guidance allows companies to choose between capital and expense treatment of these costs.

However, inconsistencies arise in many accounting practices as a result of the diversity of the reporting entities. Consequently, we feel that strict guidance on accounting for internal use software costs is not necessary and that reporting entities should have the option to decide whether capital or expense treatment is most appropriate.

If the AICPA determines that guidance is necessary, we strongly oppose the direction that the statement of position has taken. It is inappropriate to require the capitalization of all internal use software costs because this conclusion is not consistent with the FASB's conclusions regarding future benefit and capitalization. Also, the distinction between internal use software costs and other costs is subjective and will promote inconsistent reporting practices between different entities, thus defeating the purpose of the statement of position. Furthermore, any benefits derived from this disclosure are far outweighed by the costs to the reporting entities.

Future Benefit:

The justification for capitalizing internal use software costs is based on the assumption that there is future benefit derived from these expenditures. Clearly, future benefit is the motivation for management to incur these costs. However, the actual benefits achieved are often not clear until the project is complete and these benefits are difficult to measure.

In determining the accounting requirements for research and development costs (FAS 2), the FASB concluded that there is a "high degree of uncertainty about the future benefits" (par. 39, FAS 2) and that a "direct relationship between research and development costs and specific future revenue generation has not been demonstrated, even with the benefit of hindsight" (par. 41, FAS 2). Consequently, the FASB concluded that research and development costs should be expensed as incurred. In contrast, the FASB concluded that costs of computer software to be sold or otherwise marketed (FAS 86), should be capitalized because the future benefit is measurable.

The AICPA has cited the future benefits of internal use software to include efficiency, improvement of internal controls, better customer service, and competitive advantages (par. 50). However, these benefits are uncertain until the internal use software is actually in use. In addition, it is very difficult to measure the direct relationship between these benefits and the internal use software vs. the process improvements also defined. As such, consistency with the current accounting guidelines for research and development would dictate that the AICPA should recommend expense treatment for all internal use software costs.

Inconsistent Reporting Practices:

The statement of position attempts to distinguish between research and development costs and internal use software costs. The internal use software costs are to be capitalized when management has committed to funding the project and believes that it is probable that the project will be completed and the software will be used for its intended function. In addition, conceptual formulation, design, and testing of the project must be complete before the software costs should be capitalized. These criteria are subjective.

Furthermore, the FASB's EITF No. 96-14, "Accounting for the Costs Associated with Modifying Computer Software for the Year 2000", states that all upgrade costs of internal use software for the year 2000 should be expensed as incurred. Many new internal software initiatives are intended to improve the current systems as well as address the year 2000 issue. Therefore the distinction between software upgrades that should be accounted for using the guidance in EITF No. 96-14 and those which should be accounted for using the guidance in the statement of position is also subjective.

The subjective classifications between research and development costs, year 2000 upgrade costs, and internal use software costs could be subject to manipulation by reporting entities. Differing opinions would allow some companies to continue expense treatment of their internal use software costs while others treat these costs as capital expenditures. Consequently, the current lack of comparability between entities will continue to exist and the financial statement users will not benefit from the recommendations made in the statement of position. Alternatively, if the accounting guidance for all of these costs recommended the same treatment, there would be comparability between reporting entities.

Amortization:

Since the future benefit of internal use software costs is difficult to determine, the useful life will also be difficult to estimate. Given the pace at which technology becomes obsolete, it is reasonable to assume that most companies will amortize internal use software over a short period of time. Therefore, the difference between expense treatment of these costs and capitalization and amortization will not likely be material for many companies. As such, there is little benefit derived from tracking these costs and creating complicated internal policies to distinguish between the research and development costs and the internal use software costs which do not apply to the year 2000 upgrades.

Other:

In the letter which accompanied the AICPA's draft statement of position comments were requested on specific issues. One issue was whether the AICPA should change the criteria for distinguishing between research and development costs and internal use software costs. If changed, the statement of position would require that all internal use software costs would meet the "technologically feasible" criteria established in FAS 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed". In our opinion, the "technologically feasible" criterion is also subjective in nature. Therefore, there would be no benefit to changing the statement of position to include these criteria and the lack of comparability between reporting entities (as discussed above) would still exist.

SUMMARY

The statement of position, in our view, does not meet the goal of producing financial statements that improve the resource allocation decision making abilities of the various users. Guidance on the accounting treatment of internal use software costs is not necessary because current industry practice meets the needs of financial statement users. However, if a statement of position is to be finalized on this subject, we recommend that the guidance should require expense treatment of these costs. Expense treatment will ensure that the guidelines are consistent between the FASB and the AICPA. In addition, if the accounting treatment is the same for research and development costs, year 2000 upgrade costs, and internal use software costs, then the subjective distinction between these types of costs is less important. Therefore, expense treatment of internal use software costs will remove the need for complicated and costly tracking systems which segregate the different types of costs.

We appreciate the opportunity to respond to this statement of position.

Yours sincerely,

A.J. Donoghue
Vice President and Controller

Printed By: Lynda Kudrewatych 4/16/97 3:42 PM Page: 1

From: Cathy Grosso (4/16/97)

To: Nanci Adams, Susan Arnold, Francine CHABRAT, Melanie Clarke, Maggie Dickie, Valerie Elliot-Ste

CC: Debbie Noble

BCC:

Priority: Urgent Date sent: 4/16/97 3:28 PM

Biography

4/16/9

2:17 PM

Donald Schuenke, in conjunction with the Corporate Secretary's office, would like a Board Manual prepared for each of the directors.

As part of the information provided to each director, there is a section on senior management which will include a biography on every executive.

I would appreciate it if I could impose on you to provide me with such a biography at your earliest convenience. A soft copy via Q-mail would be most appreciated.

- more -

Many thanks,

Cathy Grosso

Coopers
&Lybrand

Coopers & Lybrand L.L.P.

a professional services firm

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Jersey City, New Jersey
07302

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April 22, 1997

Mr. Dan Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

Dear Mr. Noll:

Coopers & Lybrand L.L.P. is pleased to comment on the proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (the "proposed SOP"). We generally support the overall concept of capitalizing both purchased and internally developed software costs as an asset and believe that a capitalization model is fundamentally consistent with the notion that software can be an important strategic and economic resource which will benefit future periods. However, given the rapid pace of technological advances, there are cases in which the useful life of internal-use software is less than one year. In other cases, the cost of annual maintenance or of annual upgrades or enhancements to the software can be as much as the initial capitalized costs. In such cases, the cost/benefit relationship of requiring capitalization is questionable. We therefore suggest that the proposed SOP specifically allow for expensing software development costs if the life of the product is expected to be less than one year or if the expected annual cost of maintenance and/or enhancements is substantial in relation to the initial capitalized costs.

We also believe that there are significant implementation issues that need to be addressed with additional guidance, illustrative examples, or a combination of both. These issues include identifying internal-use software, upgrades, enhancements, and impairment issues which we will comment upon later in this letter. In this regard, we suggest that AcSEC consider adding a background section to the proposed SOP that would address the software development process, as well as audit and other implementation issues. We suggest that this guidance be modeled after that which was provided in Statement of Position 96-1, *Environmental Remediation Liabilities*.

With respect to cost/benefit issues, based on discussions with a number of our clients, we understand that in many cases the cost of reporting internal-use software as assets may exceed the benefits of such reporting. This is particularly the case in the situations referred to above where the estimated useful life of the software is less than one year or maintenance costs are expected to be substantial. We suggest that AcSEC work closely with financial statement preparers to ensure that a cost/benefit test is met prior to issuing a final standard.

<u>Conceptual Basis</u>

In today's business environment, billions of dollars are spent each year developing internal-use software. Evidence is emerging that more and more business combinations are motivated by the information technology possessed by target companies, and companies are using technology for competitive advantage. All these indicate that companies view software as a significant asset of the enterprise. We believe that internal-use software embodies the characteristics of an asset, as defined by paragraph 26 of Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (SFAC 6). Accounting for internal-use software is currently inconsistent. Many companies capitalize purchased internal-use software but expense internal costs, while others expense all software related costs, and still others capitalize all such costs. The decision to purchase software versus developing it internally often is based on a company's sophistication, potential resource constraints, and the availability of requisite functions and features in pre-existing software. Regardless of the decision to purchase or develop software internally, a company ultimately will possess software that benefits future periods. Accordingly, a consistent accounting model for such costs, whether purchased or developed internally, appears to be appropriate.

<u>Characteristics of Internal-Use Software</u>

The distinction between internal-use software and software that is developed to be sold, leased, or otherwise marketed is critical to the consistent application of both the Proposed SOP and FASB Statement No. 86, *Accounting for the Costs of Computer Software To Be Sold, Leased, or Otherwise Marketed* (FAS 86). The proposed SOP attempts to make that distinction through a series of examples. While we agree that these examples are an excellent means of illustrating that distinction, we do not believe it is sufficiently clear how to distinguish software that is "part of a product or process to be sold" from internal-use software, or how to apply the concept of "right to use." Example (6) in Appendix A describes the software imbedded in ATM machines. Is the answer different when you consider a bank that modifies its ATM software for use by its home-banking customers? While we acknowledge that it may be impossible to articulate the distinction such that all circumstances are clearly addressed, we believe that AcSEC should attempt to further clarify this area and more clearly develop the concept behind the distinction between internal-use software and that covered by FAS 86.

We agree with the proposed SOP's requirement that an entity must follow the guidance in either the proposed SOP or FAS 86, but not both. We believe this guidance will avoid the complexity associated with allocating costs between the two standards. Further, we support the rebuttable presumption that any software that is intended for internal use and also is intended to be sold should be accounted for under FAS 86. We suggest that AcSEC consider adding guidance to paragraph 11 that would provide for approval of any marketing plans by the appropriate level of management to ensure that such plans are consistent with the company's business plans.

<u>Conversion and Re-engineering Costs</u>

AcSEC has chosen to exclude from the scope of the proposed SOP the accounting for costs of re-engineering activities and the costs of converting data from old systems to new systems. Due to the significance of such costs, the frequency with which they are incurred in connection with internal-use software projects, our belief that there is a diversity in practice, and the absence of authoritative literature, we recommend that AcSEC address the accounting for these costs, as they relate to internal-use software, in the proposed SOP.

<u>Upgrades and Enhancements</u>

Paragraph 24 of the proposed SOP notes that upgrades and enhancements should only be capitalized when they are deemed to be "significant." Paragraph 64 of the proposed SOP stipulates that AcSEC based its conclusions regarding upgrades, enhancements, and maintenance activities on those definitions in FAS 86. However, FAS 86 does not distinguish between "significant" and "insignificant" enhancements. Rather, it differentiates only between "maintenance" and "enhancement" activities. We suggest that AcSEC reconsider whether its conclusions should be modified to be consistent with the distinctions found in FAS 86. Further, given the potential complexity of distinguishing enhancements from maintenance, we also recommend that AcSEC include several examples in the proposed SOP to assist in making that distinction.

<u>Capitalizable Costs</u>

We agree with limiting costs eligible for capitalization to those costs specified in paragraph 26 of the ED. Further, we concur with AcSEC's decision to exclude overhead costs from capitalizable costs, due to a reliable allocation measure not being determinable and the difficulty in determining a direct benefit of such costs.

We also agree with AcSEC's decision not to employ the concept of "technological feasibility" as that concept is used in FAS 86. We believe the use of the "preliminary project stage" milestone conforms more closely with a fixed asset model and contemplates the greater degree of certainty that is inherent in most internal-use software projects.

Software with Training and Maintenance Fees Built into the Purchase Price

For purchased software, the proposed SOP requires companies to estimate the amount of the total cost attributable to training and maintenance components and to account for those costs separately. The proposed SOP provides that those costs be allocated based on amounts specified in the agreement or, if not specified, in a manner similar to executory costs for leases. Consistent with the guidance provided in the proposed Statement of Position entitled *Software Revenue Recognition*, we believe the proposed SOP should require the allocation of the total cost to be based on the relative fair values of the components, whether or not specified in the agreement.

Impairments

The proposed SOP states that impairment of capitalized internal-use software should be recognized and measured in accordance with FASB Statement No 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of* (FAS 121). Since internal-use software normally does not have identifiable cash flows that are largely independent of other asset groupings, paragraph 10 of FAS 121 would appear to require that cash flows be evaluated at the level of the entity in which the software is used. Inasmuch as an entity level test rarely would result in a required impairment charge, we believe that applying the provisions of FAS 121 to internal-use software may be very difficult absent further guidance from AcSEC or the FASB.

Paragraph 29 of the proposed SOP indicates that there is a rebuttable presumption that when it is no longer probable that software will be completed, such in-process software has a fair value of zero. Paragraph 29 also provides indicators that should be considered when determining if software is no longer expected to be completed. We recommend that paragraph 29 be expanded to indicate that the evaluation for impairment is an exercise that requires professional judgment and that the indicators listed in that paragraph are intended to be used as a reference. If such additional guidance is not provided, we are concerned that the indicators will be interpreted literally causing companies to evaluate in-process software prematurely (i.e., each time a budget overrun occurs) and cause an undue burden. Further, the long-term consequences likely would be that the impairment indicators would be rendered ineffective.

We also believe that the guidance should be expanded to address impairment concerns that may originate from a significant modification to a development plan or partial abandonment of software. It has been our experience that large software development projects often encounter significant modifications (i.e., significant architectural changes and/or significant product design changes) which may result in some or all of the development effort that occurred prior to those modifications not being utilized in the final product. We also are concerned that there may be situations when the use of a particular piece of software is abandoned, calling into question the recoverability of such previously capitalized costs. Examples of such situations include:

- A software package being originally developed for five divisions of a company and a year later three of the divisions decide to switch to another software package even though the existing software is complete and operative. The software continues to be used in the remaining two divisions and the cash flows of those divisions do not indicate an impairment problem.

- A software development project is initially scheduled to include 75 different functions and features. Subsequent to commencing the program instruction stage and after capitalizing development costs, management makes the decision to discontinue the development of 25 of those functions and features. The software (with the remaining 50 functions and features) is still expected to be developed and the enterprise cash flows do not indicate an impairment problem for the costs of the software (including costs incurred to partially develop the 25 functions and features that were subsequently abandoned).

In order to address those issues, we believe that additional indicators should be added to the proposed SOP that would identify significant modifications and partial write-offs as a reason for an impairment evaluation. In those situations, we would support a rebuttable presumption that such previously capitalized costs (or allocable percentage of costs) have a fair market value of zero and, therefore, should be written off unless persuasive evidence exists to the contrary.

We recognize that the FASB is currently working on a project that addresses implementation questions relating to FAS 121 that may help mitigate certain of those issues.

<u>Amortization Periods</u>

Paragraph 30 of the proposed SOP stipulates that "costs of computer software...should be amortized in a systematic and rational manner over the estimated useful life of the software." We believe this limited guidance could result in a wide range of useful lives emerging in practice. Accordingly, we encourage AcSEC to provide more explicit guidance related to the factors to consider when evaluating amortization periods and the method of amortization. In addition, we suggest that further guidance be added to paragraph 30 which would establish a rebuttable presumption that the software's amortization period should be relatively short (i.e., not in excess of five to ten years). Finally, we suggest that the proposed SOP require that capitalized software costs be amortized on a straight-line basis, unless some other method is clearly more appropriate.

The Implementation Provisions

The transition provisions of the proposed SOP stipulate that the proposed SOP will be effective for fiscal years beginning after December 15, 1997 and apply to all projects, including those projects in progress. We recommend that the provisions of the proposed SOP be applied to projects that commence subsequent to the date of adoption, as opposed to projects that are in progress as of that same date. We do not believe it would be appropriate to account for a particular project partially as a period expense and partially as an asset eligible for capitalization.

Background and Audit Guidance

Given the complexity associated with the accounting for internal-use software, we believe the background and audit guidance similar to that contained in Statement of Position 96-1, *Environmental Remediation Liabilities*, should be added to the proposed SOP. Such guidance should address the software development process and the application of generally accepted auditing standards (GAAS) to the audit of an entity's financial statements as it relates to capitalized internal-use software. Specifically, such guidance should address the following:

- **Understanding the software development process.** Auditors are required to obtain a level of knowledge about an entity's business, organization, and its operating characteristics that will enable them to plan and perform the audit in accordance with GAAS. Guidance on how an auditor will obtain the requisite level of knowledge regarding a company's software development process would be beneficial. Emphasis should be placed on preliminary project stage indicators and how those indicators help validate when capitalization should commence.

- **Audit objectives and assessing audit risk associated with capitalized internal-use software.** Guidance should be developed to help auditors identify the relevant financial statement assertions and the related audit objectives associated with the development of internal-use software. Additionally, specific audit risks related to the software development process should be developed to assist auditors in developing their audit risk assessments.

- **Substantive audit procedures relevant to capitalized internal-use software.** Substantive audit procedures are designed to obtain sufficient evidential matter related to specific audit objectives. Guidance should be developed to aid auditors in developing adequate tests for each audit objective. Such procedures should focus on the process used by management to identify capitalizable costs, warning signals or "red flags" associated with potential impairment concerns, guidance on how individual components may be identified within a particular development project, and assessing the reasonableness of an estimated useful life assigned to a particular project.

- **Use of a specialist.** Because of the complexity of developing a software, management and/or auditors may rely upon a specialist to quantify or substantiate assertions associated with software development costs. Guidance should be developed to assist auditors in their assessment of a specialist, their reliance on a specialist's work, and evaluating the specialist's relationship with the client.

- **Client representations.** An auditor may want to obtain certain written representations from their client related to the capitalization of software development costs. Guidance should be developed that would assist an auditor in determining what circumstances warrant written representation from a client.

<u>Other Comments</u>

Finally, we want to caution AcSEC that because a "conceptual framework" does not currently exist for all "soft costs," financial statement preparers may attempt to analogize to the proposed SOP and argue that capitalization of other soft costs is appropriate. Therefore, we believe that the development of a conceptual framework for all soft costs should be developed. We recommend that a statement be made in the proposed SOP that would state that the conclusions relate to internal-use software only and should not be used as analogy to other areas.

******

We appreciate the opportunity to provide our input in this process. If you have any questions, please contact James F. Harrington at (201) 521-3039 or John P. Glynn at (201) 521-3049.

Very truly yours,

Coopers & Lybrand LLP

Warner-Lambert Company
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Morris Plains, NJ 07950
201 540-2592
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Joseph E. Lynch
Vice President & Controller

WARNER LAMBERT

April 17, 1997

Mr. Daniel Noll
Technical Manager - Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

Warner-Lambert Company, a worldwide provider of healthcare and consumer products with sales exceeding $7 billion welcomes the opportunity to comment on the proposed Statement of Position - *"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"*. In summary, we agree with the proposed SOP and support your efforts to establish a consistent standard in this area. We offer the following comments, which are numbered corresponding to the questions raised in the proposed SOP.

1) Should the costs of computer software developed or obtained for internal use be recognized as assets?

> Yes. Costs of computer software for internal use should be capitalized. Often, business support requires significant investment in application systems. These systems may provide benefit for many years similar to hard assets which are capitalized.

Should entities have the option to capitalize or expense such costs?

> No. Consistent capitalization policies will make financial statements more comparable. Companies should be required to capitalize software costs with no option to expense.

Do the benefits of reporting those costs as assets exceed the costs of reporting? What are the costs of reporting?

Yes. Companies will establish cutoff policies (e.g. $100,000) so that costs do not override the benefits. The costs of capitalizing and reporting software costs would probably be minimal since companies would likely use existing fixed asset control systems.

2) Should the SOP specify that amortization not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

The SOP should not specify a maximum amortization period. Companies are in the best position to judge the appropriate useful lives based on the circumstances. Likewise, the SOP should allow the choice of straight-line verses accelerated methods and not require a specific method of amortization. If the SOP does provide specific guidelines for amortization periods, a distinction should be made between major integrated systems which should be longer lived than desktop and other minor software.

3) Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121. If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment?

Guidance in the SOP should be simplified with a standard that would require that upon completion of a software project if the software doesn't meet its functional objective, the carrying book value should be expensed or reduced to fair market value. Applying FAS 121 to corporate internally developed software where cash flows are not measurable, will make a simple decision very complex. If software is not functional, it should be written off.

4) This proposed SOP does not require that an entity meet technological feasibility criteria before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

No. An entity should not be required to meet technological feasibility criteria before capitalizing software costs. As stated in the SOP draft, the development risks associated with creating internal-use software are conceptually no different from development risks associated with creating other assets such as high-tech automated plants. It is appropriate for entities at the start of both types of projects to expect they will be completed successfully and will provide a future benefit. The requirement to meet technological feasibility criteria in SFAS No. 86 stems from the view that software is a "soft" asset similar to advertising and some R&D (e.g. patents, licenses). Since it is uncertain when or whether the value of a soft asset will be recoverable, it would be appropriate, depending on the degree of risk, to either expense some costs up front such as R&D or limit when and how long a soft asset, such as advertising, may be placed on the balance sheet. We believe the risk factor for completing internal use software projects is not nearly as great as the risk factor for R&D projects or advertising.

5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? What costs should be included or excluded?

The SOP should be clear about what types of payroll costs should be capitalized. For example, should costs be capitalized for non-technical project managers, end users, and non MIS staff?

Also, the SOP states that training costs should be expensed because entities are not able to identify the specific future period which benefits from the training. When training costs are included in the purchase price of the software, it is evident that training (e.g. cost of the trainer) is an integral cost of the software. Without training the software has little utility. We do not believe that these costs should be carved out and expensed. We suggest that training costs be capitalized and amortized over the same period as the software because future periods clearly benefit. However, post implementation training (i.e. regular ongoing training) should be expensed.

6) The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

More guidance is needed in this area. For example, it is not clear if the upgrade from Windows version 3.1 to Windows 95 should be capitalized or expensed. On one hand expense seems appropriate because it is a routine change and on the other hand it seems capitalization is appropriate because it is an upgrade and increases functionality. This area needs more clarification.

Additional functionality is defined as changes to the software so that it may perform a task that it is currently unable to perform. We suggest adding to that last sentence - "or perform a task more efficiently than the software was able to perform when it was fully operational."

Other Issues

As mentioned in paragraph 10, the scope of the proposal excludes costs of reengineering and the costs of converting data from old systems to new systems. We believe reengineering costs should be included in the scope of the SOP. If these are excluded from the SOP, we suggest including an explanation in the conclusion section why these are excluded. Some systems projects include substantial costs to convert data from the old system to the new. The SOP should address this issue. We believe conversion costs should be capitalized since in many cases it is impractical or at least very difficult to separate conversion costs from development or implementation efforts.

As pointed out in the proposed SOP, there is substantial diversity of accounting policy and treatment in practice today. The result is that financial statements of different companies are not comparable. Given the major systems projects currently underway at many companies, we strongly encourage the AICPA to proceed as quickly as possible to finalize the SOP for implementation by the proposed effective date.

If you would like to discuss any of these issues with me, please do not hesitate to call.

Sincerely,

Joseph E. Lynch

AICPA.doc

ERNST & YOUNG LLP

1285 Avenue of the Americas
New York, New York 10019

~~Phone: 212~~ 773 3000

April 22, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Proposed Statement of Position,
"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"
(File 4262)

Dear Mr. Noll:

We are pleased to provide comments on the above-referenced proposal. Although we generally support the AICPA's proposal, our preference would have been to allow capitalization, but not require it, because some companies would rather continue their conservative policy of expensing these costs as incurred. However, we recognize that AcSEC as well as the SEC and the FASB believe the new standard should reduce diversity. Accordingly, we believe a final standard should be issued. While a goal is to reduce diversity in practice, we note that companies will continue to have different views about the uncertainties associated with various software development projects based on their particular facts and circumstances. Therefore, there will be different points at which capitalization will begin. Paragraph 20 of the proposed SOP accommodates differing judgments and provides appropriate flexibility for differing circumstances.

We have some concerns about certain aspects of the proposal, including the scope of the proposal with regard to reengineering and data conversion costs and the application of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* These concerns are discussed below.

Reengineering and Data Conversion Costs

Costs of reengineering operations and converting data from old systems to new systems are excluded from the scope of the proposal. These costs can represent a large component of the total costs to develop and implement new software systems. Further, the implementation of a new software system might require significant reengineering and data conversion efforts in order to ensure desired functionality and success of the overall project. Some believe these reengineering and data conversion costs cannot be separated from the software project and consequently will capitalize these costs as part of the project. Others believe these costs are similar to restructuring costs and will expense them in accordance with EITF Issue 94-3. Therefore, diversity in practice may continue unless the SOP clearly defines the range of these activities and addresses the appropriate accounting for them.

We generally believe that reengineering and conversion costs incurred on a stand alone basis should be expensed as incurred. However, when these costs are incurred in connection with the development and implementation of a new software system, the appropriate accounting treatment is less clear. Accordingly, we believe AcSEC should revise the scope of the project and address this very important issue. Guidance is needed for these costs; otherwise, the SOP would be incomplete.

If the scope of the proposed SOP is not changed to include reengineering and data conversion costs, we believe that AcSEC should, at a minimum, provide a clear definition of the costs covered by the SOP, and allocation guidance for installation contracts that do not provide a breakdown of the total contract price.

Impairment

The proposal indicates that capitalized costs of internal-use software should be evaluated for impairment in accordance with Statement 121, and provides examples of indicators of impairment. While the proposal is fairly clear on how to handle software projects in process, we believe that additional guidance is needed regarding the application of Statement 121 after the software has been initially placed in use. Internal use software used in connection with revenue producing activities will be evaluated based on an assessment of future cash flows. However, internal use software typically is not associated with revenue producing activities. Therefore, the only relevant impairment indicator appears to be management's decision to replace the software. Even then, there is a question as to how to measure impairment. For example, assume software has been placed in use and is being amortized over its estimated useful life of five years. In year two, management decides to replace the software with a new system that may take two years to complete. Using a "held for sale" model, one could conclude that the fair value is zero and write off the remaining capitalized costs. Another more logical approach would be to revise the remaining amortization period to write off the remaining costs over the two years until completion of the new software.

Training and Maintenance

The proposal would require training and maintenance costs to be expensed as incurred. Further, paragraph 27 of the proposal requires bifurcation of the total contract price, to training and maintenance, if the contract does not provide an allocation of the total contract price. We believe that in many cases, the costs of performing this allocation would exceed the benefit provided. For many software projects, this aspect of the project is likely to be immaterial. Although the overall SOP is subject to materiality considerations, we believe it would be helpful to preparers for AcSEC to acknowledge in this section of the SOP that it would not require bifurcation of contract prices that contain immaterial amounts of training and maintenance.

Amortization

The proposal does not specify a maximum amortization period, and we agree with this position. However, the proposal requires that amortization begin when the software project is ready for its intended use. We believe that amortization of internal use software costs should begin when the software is initially *placed* in use. For example, assume a company completes a software project in November 1996. However, in order to allow a smooth transition, the company decides to begin using the software system in January 1997. We believe that the company's operations, for 1996, should not be charged for amortization related to November and December of 1996.

Other Comments

AcSEC should carefully evaluate preparer input to assess the operationality of the criteria for determining if software is for internal use, the clarity of the guidance on distinguishing research and development costs from capitalizable costs, and the costs and benefits of tracking amounts that would have to be capitalized under the proposal.

We appreciate the opportunity to present our views on the proposal and would be pleased to discuss our letter with AcSEC or the AICPA staff at your convenience.

Very truly yours,

Ernst + Young LLP

Union Pacific Corporation

Joseph E. O'Connor, Jr.
Vice President and Controller

April 16, 1997

American Institute of Certified Public Accountants
Attention of Mr. Daniel Noll, Technical Manager
File Reference No. 4262
1211 Avenue of the Americas
New York, New York 10036-8775

Gentlemen:

Union Pacific Corporation (UPC) appreciates the opportunity to respond to the AICPA's exposure draft, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

Our principal comments are contained in the attached response. We would appreciate your consideration of our recommendations. We feel that these recommendations will result in improving the reporting of capitalized software within financial statements.

Sincerely,

JEO:dmw
Attachment

Martin Tower, Eighth and Eaton Avenues, Bethlehem, PA 18018 • 610 861 3261

ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE

Issue 1
UPC concurs with the AcSEC's conclusion that computer software developed internally or obtained for internal use should be recognized as an asset since it clearly meets the FASB Concepts Statement No. 6 definition of an Asset. More specifically, the software will provide a future economic benefit to the organization and the organization has invested time and resources in the development and assessment or purchase of the software.

Organizations should not be given the option of capitalizing or expensing software development costs. The rules contained in the Exposure Draft were developed with the intention of making the practice of software capitalization consistent for financial statements of all industries and companies. Providing the option of capitalizing or expensing software would eliminate consistency.

Issue 2
UPC agrees with the Exposure Draft's contention that each entity should determine its own period of amortization.

UPC recommends that the Exposure Draft specify (beyond what is indicated in paragraph 34) that the period and method of software amortization be provided in the notes to the financial statements, if material. This requirement will enable financial statement users to differentiate material variances in amortization methods.

Issue 3
UPC agrees with the Exposure Draft's conclusion that software is a long-lived asset as described in Financial Accounting Standards Board Statement No. 121. Impairment of capitalized software should be measured using the guidance of Statement No. 121.

Issue 4
UPC concurs with the Exposure Draft's conclusion that software costs should not be required to meet "technological feasibility" criteria before capitalization can begin. In many cases, this requirement would exclude a majority of the software development costs from the amount to be capitalized and amortized over the benefit period. Rather, these software development projects should be evaluated as a long-lived asset under Statement No. 121.

Issues 5 and 6
UPC believes that the Exposure Draft includes an adequate description of capital and period software costs. By excluding general and administrative, overhead and training costs from costs permitted to be capitalized, AcSEC has effectively limited the amount of "soft costs" included in capital expenditures. The Exposure Draft also provides sufficient guidance to help entities determine if software is for internal use.

Issue 7
UPC does not agree with the Exposure Draft's position that software developed or obtained for both internal use and external marketed cannot be allocated. In general, in today's cost conscious world, significant economic analysis is performed before cash expenditures occur on any project. Therefore, it is reasonable to suggest that organizations should be able to determine, with reasonable certainty, the percentage of costs to be allocated between internal-use software and software to be marketed before any cash outlay occurs. As a result, UPC believes that the accounting for software development costs can and should be split between this Exposure Draft and FASB Statement No. 86. This bifurcated approach would result in costs allocated to internal-use software being treated under the guidance of this Exposure Draft while costs allocated to software to be marketed being treated under Statement No. 86.

On a related point, Paragraph 33 of the Exposure Draft discusses the accounting for internal-use software subsequently sold. Such accounting would include the offsetting of sales proceeds against capitalized amounts. Profits would not be recognized in the Exposure Draft until all capitalized amounts are exhausted.

UPC does not agree with this approach. When the software shifts to the "software to be marketed" category, the remaining amount of capitalized software should be amortized over the remaining economic life of the product in accordance with paragraph 8 of Statement No. 86. This treatment will more appropriately match the costs of software development with the revenues generated by the sale of the software.

Issue 8
UPC believes that the guidance distinguishing between software maintenance and software enhancements is operational and should be retained in the final Statement of Position.

Consumers Energy

A CMS Energy Company

General Offices
212 West Michigan Avenue
Jackson, MI 49201-2277

Tel: 517 788 0550

April 17, 1997

AICPA
Daniel Noll, Technical Manager
Accounting Standards, File 4262
1211 Avenue of the Americas
New York, NY 10036-8775

Consumers Energy Company and CMS Energy Corporation (collectively, the Company) are pleased to comment on the Exposure Draft, Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,* issued by the American Institute of Certified Public Accountants (AICPA). Consumers Energy Company is the nation's fourth-largest combination electric and gas utility and the principal subsidiary of CMS Energy Corporation. CMS Energy Corporation, whose common stock is traded on the New York and Midwest Stock Exchanges, is a diversified international and domestic energy company also engaged in independent power production, natural gas transportation and storage, gas and electric marketing, oil and gas exploration and production, and electric distribution. CMS Energy's consolidated assets are $8 billion, and annual operating revenues are $4 billion.

The Company supports the overall position proposed by the AICPA in this Exposure Draft related to the capitalization of computer software developed or obtained for internal use. The Company believes that it is appropriate to capitalize such computer software, as the cost of such software is often significant and provides probable future economic benefits. In our view, the amortization period should not be fixed, but rather flexible based upon the facts and circumstances surrounding the probable future economic benefit that the software will provide. We agree that impairment of internal-use computer software should be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* While we concur with the overall position of the Exposure Draft, we would like to offer our differing comments regarding the components of capitalizable costs.

In our view, capitalizable costs should include certain costs incurred in what is termed, the preliminary project stage. Costs incurred at this stage of the process are often significant, and have a direct correlation to the purchase or creation of the software ultimately obtained. It is our belief, that once management has approved the project as a go forward project, all costs incurred from that point on should be capitalized. This could include costs incurred prior to the actual customization programming, such as, costs incurred to determine the specific requirements needed in the software, the development of requests for proposals from software vendors, preliminary modification design, which includes evaluation of software for compatibility and plans for customization for integration into current systems. We believe these costs are incurred specifically and directly for the purchase or creation of the ultimate software obtained, and as such should be capitalized. However, if conceptual formulation is at a general level, and occurs before authorization is given by management to proceed with the project, than we believe these costs should be expensed.

As a utility regulated by the Federal Energy Regulatory Commission, certain training costs are required to be capitalized. Training costs to be capitalized include costs to train employees to operate or maintain facilities which are not conventional in nature, or are new to the company's operations. Once placed in service, capitalization of training costs cease and subsequent costs are expensed. Accordingly, the Company supports the capitalization of initial training costs required for system implementation, and costs to develop training materials.

The Company appreciates the opportunity to contribute to the standard-setting process and hopes these comments will be useful in the AICPA's deliberations.

Sincerely,

Dennis DaPra
Vice President and Controller
Consumers Energy Company

Preston D. Hopper
Senior Vice President, Controller
and Chief Accounting Officer
CMS Energy Corporation

THE ROBERT MORRIS ASSOCIATES
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April 14, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The Accounting Policy Committee (APC) of The Robert Morris Associates (RMA) is pleased to comment on the Accounting Standards Executive Committee's (AcSEC) *Proposed Statement of Position*, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"(ED). RMA is an association representing over 18,000 lending and credit risk officers from institutions across North America responsible for approximately eighty percent of total banking assets. The APC is the RMA committee charged to work for the continuous improvement in the quality of financial information available to credit grantors. Our responses on accounting and financial reporting issues are, therefore, primarily from the financial statement users' perspective and, more particularly, from the perspective of those who lend or participate in the lending and credit process.

Computer Software Costs and Credit Evaluation

Computer software is an intangible asset and, as such, is difficult to evaluate in a lending circumstance. Lenders use financial statements primarily to assist them in assessing the ability of borrowers to service their debts. Debt service in turn requires cash. Thus, lenders spend much analytic effort assessing an enterprise's prospective cash flows. The primary source for debt repayment is the cash flow generated by operating activities. The secondary sources are: (1) the possibility of refunding the debt with new debt or equity capital (financing cash flows); and (2) funding debt service through the sales of assets (investing cash flows).

Computer software costs have only one easily measurable effect on cash flow — their use of operating cash flows at the time of their acquisition or development. The net positive effect on operating cash flows from using acquired or self-developed software is virtually impossible to measure, and computer software used internally has virtually no cash value in liquidation. In fact, most lenders employ *tangible* net worth in their analytic procedures. Consequently, the capitalization of computer software costs has minimal impact on lending decisions. Most lenders will disregard all but the current expenditures in their quantitative credit assessments.

However, that does not mean that lenders are unaware that expenditures on computer software can create significant value, and that the value generally extends over several future accounting periods. They just are uneasy in having the financial statements measure that value in the amounts spent to obtain or develop the software. Those amounts simply are not useful in the credit-evaluation process. Nevertheless, there must be sensible ways to account for the costs of internal-use computer software. It is in that light we provide the following comments on the Accounting Standards Executive Committee's *Proposed Statement of Position*.

Comments on Specific Issues

Direct versus Full Cost

The APC agrees that, if software acquisition costs are to be capitalized, only the direct costs of the acquisition should be included. Indirect costs and overhead should be expensed. We agree that capital costs should be limited to incremental costs. As a collateral matter, the APC believes the AcSEC has properly and rigorously distinguished software acquisitions from maintenance so as to exclude from capitalization all but those costs that really will provide new economic benefits.

Depreciable Life

The APC agrees with the ED that the software costs should be amortized over their estimated economic lives. Furthermore, the lives used should be short ones because the software has no alternative use or recovery value in case it becomes obsolete or is otherwise superceded.

Amortization Method

The risk of obsolescence is so great with computer software that the APC believes that it justifies requiring that accelerated amortization methods be used. We urge AcSEC to issue a final *Statement of Position* that requires accelerated amortization of any costs that are allowed to be capitalized.

Test for Technological Feasibility

The APC believes that the principles underlying software cost capitalization ought to be the same regardless of whether the software is to be used internally or is to be sold or licensed. Thus, we recommend that the ED be changed to require a technological feasibility test be met for internal-use software in the same manner that it must be met for software covered by *Statement of Financial Accounting Standards No. 86*. Enterprises should be required to expense all costs incurred prior to the establishment of technological feasibility and to capitalize all costs incurred after that date.[1] [2]

[1]Some APC members believe that even the direct costs ought to be expensed in the period in which they are

Impairment Under FAS 121

As stated earlier in this letter, we do not believe it is possible to determine the separate future net cash flows attributable to computer software used for internal purposes. The software is such an integral part of the operations or other activities for which it is used, that we do not believe it is possible, as required by FAS 121, to determine whether or not the unamortized costs of the software exceed or fall short of the undiscounted future cash flows attributable to it. Therefore, we do not believe it is appropriate for the proposed *Statement of Position* to require impairment tests and procedures to be applied to internal-use computer software. However, if our other recommendations, including a feasibility test, short lives for amortization, and required use of double-declining balance amortization, are adopted, impairment should arise only in extreme rare instances.

Proceeds of "Sales"

The ED proposes that any revenue from selling or licensing software developed or acquired for internal use be recorded as a recovery of the unamortized cost of the software. The APC agrees that no profit should be recognized on such "sales" until all costs have been recovered. However, we believe sales ought to be recorded as revenues and displayed as such on the income statement with a "cost of software sales" recorded as a separate item also on the income statement. Otherwise, financial statement users could be unaware of the existence of such sales.

As a complement to our comment about "sales", we believe the AcSEC has done an excellent job in defining software developed or acquired for internal use with sufficient rigor and restrictiveness that such "sales" should only rarely be encountered.

Disclosures

Even though the APC believes, as stated above, that capitalization of software costs should be extremely limited, it also is aware that substantial economic values can be created. Therefore, it is essential that both enterprise managers and financial statement users be aware of just how much is being spent to create those values. Thus, there should be required disclosure each period in the financial statements of the following matters:

The total cost incurred during the current period to develop and acquire internal-use software.

The cost incurred during the current period for each material internal-use software project.

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incurred.

[2]If at some future date FAS 86 should be amended or superceded, this SOP should be changed accordingly.

The aggregate cost to date to develop and acquire internal-use software, including amounts of individual projects, if material.

Descriptions of the projects in process and the degree of progress to date in achieving their successful completion, including a statement of the benefits they will produce.

Concluding Remarks

Computer software presents new challenges for accounting standard setters, in terms of both revenue recognition and cost disposition. We welcome and endorse the work of both the Financial Accounting Standards Board (FASB)and the AcSEC in these areas. We also are aware that today's accounting methods are incapable of measuring with perfection the actual values created in the production of computer software. Because those values defy even approximate measurement, and because cost is such a poor measure of those values, the APC's recommendations tend to support only very conservative accounting. If the values exist in fact they eventually will be substantiated in the form of actual future cash flows. However, it is our view that such flows should not be anticipated by possibly capitalizing excessive costs.

On behalf of RMA, the Accounting Policy Committee appreciates the opportunity to respond to the Accounting Standards Executive Committee's *Proposed Statement of Position*, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." We would be pleased to answer any questions you or the members of AcSEC may have concerning our views.

Yours very truly,

Douglas F. Nelson

Douglas F. Nelson, CPA
Chairman, Accounting Policy Committee

WACHOVIA

Albert J. DeForest III
Comptroller

Wachovia Bank of North Carolina, N. A.
Post Office Box 3099
Winston-Salem, NC 27150

April 22, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
File Reference 4262
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Noll:

Wachovia appreciates the opportunity to submit our comments on the Proposed Statement of Position: *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Wachovia Corporation is a publicly traded bank holding company listed on the New York Stock Exchange. As of December 31, 1996, Wachovia Corporation had assets of $46.9 billion and total 1996 net income of $644.6 million. The amount of internally developed software expensed that could have been capitalized during 1996 was immaterial in comparison to our total other expense base of $1.258 billion.

The Institute believes internally developed software is an asset that should be capitalized and amortized into the earnings stream over the expected life of the software. Wachovia believes that no benefit would be derived from capitalizing the costs of internally developed software. With the rapid and changing pace of technological advancement in software development, it would be increasingly difficult to estimate the useful life of internally developed software. The useful life of externally purchased software has also become difficult to estimate. Internally developed software system upgrades should be viewed as ongoing operating activities whose costs should be expensed as incurred. Many of these internal efforts to improve functionality merely maintain an acceptable level of operational efficiency. If capitalized, these internal upgrades would most likely become impaired quickly. Wachovia believes the current method of expensing internally developed software is widely accepted, understood across multiple industries, and should not be changed for comparability reasons. In a similar manner, the purchase of external vendor developed software is usually such a minor component of the implementation costs that it possibly should be treated as a period cost as well. Timing recognition distinction regarding externally purchased software for internal use may be justified on the following basis: the lump-sum cash expenditure for a developed "off-the-shelf" package should be allocated in future time periods similar to the timeframe that it would have taken to develop the enhancement in-house. Following this practice, internally developed or purchased software efforts would flow through earnings in a similar manner (if it would take four years of internal effort to develop, then amortize purchased software over four years). We believe the current overwhelming practice across diverse industries is to expense internally developed software costs as incurred. The predominant practice treats these expenditures as normal, ongoing costs that are a component of the annual core expense base.

We have provided responses to the specific questions listed in the proposal.

1. *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting?*

It has been Wachovia's practice to view internally developed software as an ongoing operational expense when the cost was incurred. We view our business differently from that of a software vendor who needs to defer expenses while developing a package for sale to the general public (per SFAS No. 86). Wachovia feels that the deferral of internal enhancement costs into future periods will not have a significant impact on current period earnings. This approach will soon be a zero sum game with amortization periods that flow this expense back through earnings in a short period of time. The annual expenditure for internally developed enhancements may initially appear significant in dollars until it is compared to the overall expense base (annually it is less than 1% of Other Expenses for Wachovia based on our definition of a significant new enhancement). It is Wachovia's feeling that an option to elect to capitalize or to expense would cloud the consistency and comparability of publicly reported companies' financial results. Wachovia currently has over 100 application systems that are constantly being maintained, modified and improved. The costs of defining and determining a useful life for these system modifications does not justify the benefits received for this proposed tracking.

2. *This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

The AICPA stated in SOP 93-7, *Reporting of Advertising Costs,* that:

1) Financial statement preparers generally presumed that the benefit period was too short to capitalize as an asset.
2) The periods during which the future economic benefits would be received, and the amounts of such benefits could not be measured and determined easily and objectively.
3) The costs for some entities were not material.
4) Any future economic benefit that results from the expense incurred in the form of future revenue is difficult to measure accurately.

Wachovia feels that internally developed software should be treated in a similar manner as advertising costs because the factors above are analogous for internally developed software.

3. *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

Due to the dynamic and accelerated pace of technological development, it would appear that all software (whether internally developed or purchased externally) would have some measure of impairment in a very short period of time and would have to be reviewed on a periodic basis. As such, it is more appropriate to expense internal costs as incurred.

4. *This proposed SOP requires the capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use. If so what are those criteria?*

It is Wachovia's position that the current accounting model is adequate. As such, there would be no benefit derived from the costly application of "technological feasibility criteria".

5. *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded.*

All internally developed software costs should be expensed as incurred. See previous comments.

6. *Does the SOP provide guidance to help entities determine whether computer software is for internal use. Is this guidance appropriate? Why?*

It is Wachovia's opinion that no further guidance beyond current practice is necessary. All internally developed software costs should be expensed as incurred. The effort to identify enhancements versus maintenance on normal upgrades for hundreds of applications is not cost beneficial or easily determinable.

7. *Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all the characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that be used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this Proposed SOP or FASB Statement No. 86, but not both? If not how should these costs be allocated?*

If a company plans to develop software for sale to third parties singularly or through a joint venture, it appears that SFAS 86 applies.

8. *The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance useful?*

As stated earlier, due to the rapid pace of technological advancement, the line between enhancements and maintenance will become increasingly unclear. The costs of maintenance and enhancements for internally developed software should both be expensed in the period incurred. In many instances significant efforts to develop new enhancements internally take an extended period of time, are prohibitively expensive, and are not as efficient as purchasing software in the marketplace.

* * * * * * *

In conclusion, we feel that a change from the existing method of accounting for internally developed software is not warranted. The costs of obtaining this information will not produce any informational benefit and may serve to obscure the true earnings of an institution. We welcome further comments and appreciate consideration of our views.

Sincerely,

Albert J. DeForest III

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April 17, 1997

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1211 Avenue of the Americas
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RE: *Proposed Statement of Position*
Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

The Accounting Principles and Auditing Procedures Committee is the senior technical committee of the Massachusetts Society of Certified Public Accountants. The Committee consists of over thirty members who are affiliated with public accounting firms of various sizes, from sole proprietorships to international "big six" firms, as well as members in both industry and academia. The High Technology Committee of the Massachusetts Society of Certified Public Accountants consists of over fifteen members who work in the area of high-tech software and hardware in the software industry and in public accounting. Both of these Committees have reviewed and discussed the exposure draft (ED), *Proposed Statement of Position (SOP) - Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

The comments resulting from our combined discussions are summarized below. The views expressed in this letter are solely those of those Committees and do not reflect the views of the organizations with which the Committee members are affiliated.

Both Committees thought that the overall basic principles and guidelines outlined in the SOP demonstrate appropriate accounting methodology. We applaud the AICPA for recognizing the many varied ways these costs are being handled in practice and the need for more specific guidance. Several members, however, did voice their strong concerns over the fact that EITF 96-14 was not changed, and that the costs to modify the computer software for the year 2000 conversion are not included under this exposure draft. These members believe that the benefit derived from these conversion costs have definite long- lasting effects.

MASSACHUSETTS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, Inc.
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Also, several of our members in industry are a bit uneasy capitalizing these types of costs due to their past experiences in incorrectly budgeting the estimates of the future benefit to the Company. They noted that many in industry expense these costs as period costs internally for budgeting purposes.

We appreciate the opportunity to present our comments and thank you for your consideration.

Very truly yours,

Thomas J. Vocatura

Thomas J. Vocatura, Chairman
MSCPA Accounting and Auditing Committee

April 25, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Merrill Lynch

Dear Mr. Noll:

We appreciate the opportunity to respond to the Accounting Standards Executive Committee on its *Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

We applaud the Committee's efforts to create guidance to improve the current accounting practices for the costs of internal-use software and the consistency of application. Additionally, we (i) believe that the definition of internal-use software provided in the proposed SOP is concise and straightforward, (ii) concur that costs of maintenance activities as well as general and administrative, overhead, and training costs as they relate to internal-use software should be expensed, (iii) acknowledge the *theoretical* presumption that software developed for internal use has the essential characteristics of an asset, and (iv) understand the view that there should be no *theoretical* difference between the treatment of internally developed versus purchased software for internal use.

Nevertheless, in practice, internal-use software may not always have all of the necessary characteristics of an asset, leading to improper capitalization and, in all likelihood, future write-offs. This concern relates to internally developed or significantly modified purchased software, as opposed to purchased software with little or no modification. We are also concerned that the proposed capitalization guidance is subjective and likely to result in inconsistencies in application. In addition, the proposed guidance may induce management to make decisions for accounting reasons rather than economic reasons. As such, we believe that it is inappropriate to capitalize the costs related to internally developed or significantly modified purchased software. The following elaborates on the rationale for our position.

Asset Qualification
We believe that software costs must meet the definition of an asset in FASB Concept Statement No. 6. That definition requires that the software "embodies a probable future benefit." Purchased software that has had little or no modifications meets the definition of an asset. The future benefit is more certain since the functionality of the software is usually proven prior to acquisition and implementation.

It is often difficult to assess at the end of the preliminary project stage the probability of achieving future benefit from internally developed or significantly modified purchased software. An entity's experience with previous software projects may indicate that the entity may not receive that future benefit; for example, systems capabilities may be limiting, technological advances may render a project obsolete, or business/client needs may change. As such, we believe that it is inappropriate to assume that all internally developed or significantly modified internal-use software have the essential characteristics of an asset.

Inconsistencies in Application
The proposed SOP outlines three different stages of software development: the preliminary project, program instruction, and implementation stages. These stages provide the basis for determining when expensing ends and capitalization begins. We believe that these stages require significant interpretation and thus will lead to wide variations in application between companies and between projects within a company.

Under the proposed SOP, one company may assign certain types of costs of a software project to the preliminary project stage, while another company that has a similar software project may assign the same costs to the program instruction stage. An example is when a project faces an insurmountable obstacle during the programming phase thus requiring a return to the design phase. One interpretation of the proposed SOP may be that, because programming has begun, the project is in the program instruction stage; while another interpretation may be that, because the viability of the software design is not known, the project is in the preliminary project stage.

Further, the type of software project will influence the interpretation of the guidance, such as purchasing a software platform and customizing it, developing the software internally, or a multi-module software project with a long roll-out period or various releases.

Amortization Period
The proposed SOP leaves the determination of the amortization period to management discretion. Estimating the useful life of the software, giving consideration to obsolescence, technology, competition, and other economic factors allows for a great deal of subjectivity. The lack of objective guidance will result in inconsistencies among companies and projects.

Impairment of a Long-Lived Asset
Capitalized internal-use software would be considered a long-lived asset. If impairment

thus, their payroll and payroll-related costs should be expensed by the company.

Disclosures of Estimates
SOP 94-6 requires disclosure of estimates, such as estimates associated with long-term operating assets including capitalized computer software costs, when it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will materially change in the near future due to a confirming event. Making such estimates with respect to internal-use software would be difficult, contribute to disclosure overload, and potentially mislead readers of the financial statements.

Implementation Issues
The implementation guidelines presented in the proposed SOP require application to costs incurred in fiscal years beginning after December 15, 1997 for all projects, including those in progress. If a company is expensing the types of costs identified in the final SOP as ones that should be capitalized, the company would be required to change their accounting methodology mid-project, leading to inconsistent treatment of similar costs. We strongly disagree with the transition provisions for projects in progress.

Additionally, systems must be capable of gathering and accumulating the costs identified as capitalizable by the proposed SOP. Companies may need to complete major systems modifications in order to capture these costs.

Recommendations
We understand the desire to increase comparability and consistency of accounting for internal-use software costs. We believe, however, that expensing, not capitalizing, is more appropriate for all internally developed or significantly modified purchased software. We believe that capitalization is only appropriate for purchased software that requires little or no modification.

We recommend that the SOP give companies the option to capitalize or expense costs related to internal-use software. Although this approach would sacrifice comparability, each company would be able to set its own policy, based on its own experiences, to determine whether or not internally developed or purchased software qualifies as an asset. Further, to enhance the understanding of the users of financial statements, we would recommend that companies be required to disclose their relevant software accounting policies.

Thank you again for this opportunity to express our views on the AICPA's proposed SOP. If you have any questions, please do not hesitate to contact Sharyn Handelsman at (212) 236-6356 or me.

Very truly yours,

/s/ Michael J. Castellano

Michael J. Castellano
Senior Vice President
Controller

April 28, 1997

Mr. Dan Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)[1] is pleased to comment on the Accounting Standards Executive Committee's (AcSEC) Exposure Draft of Proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (ED). The FAPC is a standing committee of AIMR charged with maintaining liaison with and responding to initiatives of bodies that set financial accounting standards and regulate financial reporting disclosures. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

Background

In this ED the AcSEC has taken the position that the costs of developing or obtaining computer software for internal use ought to be accounted for similarly to the costs incurred when an enterprise engages in the self-construction of plant or other tangible property. That is, the direct costs of acquiring such property ought to be recorded as an asset up until the time the asset is placed in service. The ED goes on to specify that normal depreciation should be taken on the computer software asset once it is placed in service. Finally, the ED specifies that the unamortized software costs be tested for impairment and, if necessary, written down in accordance with the provisions of Statement of Financial Accounting Standards 121.

The FAPC believes the analogy between software development costs and the costs of acquiring tangible assets cannot be supported. Software is an *intangible* asset and it should be accounted

[1]AIMR is a global not-for-profit membership organization of more than 70,000 members and candidates comprising investment analysts, portfolio managers, and other investment decision-makers employed by investment management firms, banks, broker-dealers, investment company complexes, and insurance companies. AIMR members and candidates manage, directly and through their firms, over six trillion dollars in assets. The Association's mission is to serve investors through its membership by providing global leadership in education on investment knowledge, sustaining high standards of professional conduct, and administering the Chartered Financial Analyst (CFA®) designation program.

for accordingly. Our position on intangible assets is stated in AIMR's 1993 position paper, *Financial Reporting in the 1990s and Beyond*:

> We are not enamored of recording self-developed intangibles unless their values are readily apparent. We consider the cost of creating them to be so unrelated to their actual value as to be irrelevant in the investment evaluation process. Furthermore, it usually is next to impossible to determine in any sensible or codifiable manner exactly which costs provide future benefit and which do not.[2]

If one were to seek a prime example of the type of expenditure to which that quotation applies, computer software costs would rank high on the list of candidates.

Furthermore, even when such costs are permitted to be capitalized, it is extremely difficult to envision a separate stream of cash flows attributable to software used for internal purposes. Thus, impairment accounting would be virtually impossible to apply, except in the context of a larger business unit which uses that software as part of its ongoing activities.

The FAPC's Overall Position on the ED

The FAPC views AICPA Statements of Position as extensions of existing accounting standards rather than pronouncements that establish new standards where none existed previously. Therefore, it is quite proper for SOPs to include reasoning by analogy from existing accounting standards. In this case, however, we believe the proper analogy is to the accounting for computer software costs established by Statement of Financial Accounting Standards 86 (FAS 86). Furthermore, in the presumed absence of the data necessary to test for and record impairment of the computer software, we recommend that depreciation be recorded on such software costs using an accelerated method (preferably double-declining-balance) over very short expected lives.

The FAPC agrees that, whatever costs are capitalized, they should be limited to direct costs and exclude overhead or other indirect costs. However, we believe that software developed or acquired for internal use should be subject to the same technological feasibility test as is software developed for external sale or license. All costs incurred prior to the establishment of technological feasibility should be expensed (with disclosure) as research costs. Only those costs incurred after technological feasibility of the software is established should be allowed to be capitalized. Capitalization of those costs, together with their rapid amortization, should obviate the need for recording impairment. But we must point out that the resultant financial statement numbers still will lack significance for investment analysis.

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[2] See pages 50-51.

Other Matters

The FAPC does agree with some of the positions taken in the ED. We find the definition of internally-developed software (as distinguished from software for external sale or license) quite rigorous. It narrows down appropriately the types of projects that would qualify for the accounting proposed in the ED. However, our recommendation that this SOP should follow the dictates of FAS 86 makes that matter moot because we would have no difference in the accounting treatment of the costs of either type of software.

We believe that any proceeds from the sale or licensing of software developed or acquired for internal use are revenues and should be recorded as such on the income statement. The costs associated with those revenues, which we believe should be equal to the revenues until all costs are recovered, should be reported on the income statement as cost of sales. Thus, no profit would be recorded until all such cost was recovered.

Disclosure

Whenever financial accounting cannot supply definitive standards of measurement and recognition, there is a need for expanded disclosure. Such is the case here. As discussed more thoroughly in our position paper, *Financial Reporting in the 1990s and Beyond*, the FAPC is aware that sizable values may be created even though they have no tangible manifestation. Those values include computer software, other intellectual property, and a wide variety of other rights. The values are embedded in and continuously updated by the prices of the securities we evaluate. We also are aware of the impossibility of recording those values in financial statements with either reliability or timeliness. However, recording costs simply does not suffice as a surrogate for the real values omitted. Therefore, we request that the following disclosures be required in those cases where the amounts are material.

- Display or other disclosure of the gross proceeds from the sale or licensing of software developed or obtained for internal use. Such display is particularly important because the cash flows from such sales also ought to be displayed. We would view those as cash flows as being from operating, not investing activities.

- A report of the gross expenditures to develop or obtain computer software for internal use during the period, as well as their cumulative amounts. Separate reports should be made for each project that by itself is material.

- Descriptive information should be provided about the nature of the projects underway as well as an assessment of their progress to date and the prognosis for their successful completion. We must reemphasize two points: (1) that the disclosures are needed because of the inadequacies of historic cost accounting measurements; and (2) that the disclosures need to be made only for projects that are material, that is of such importance that investors could be mislead in the absence of that descriptive information.

Relation of the SOP to FAS 86

The FAPC opposes capitalization of the costs of self-developed intangible assets. It accepts capitalization of the costs of software developed or obtained for internal use only to the extent of the precedent set by FAS 86. It has come to our attention that the Financial Accounting Standards Board (FASB) has been asked by members of the computer software industry to rescind FAS 86 and, in its place, require all software development costs to be expensed as incurred. Should the FASB act on that request, then we believe AcSEC ought to take identical action with respect to the software development costs addressed by this ED.

Concluding Remarks

The FAPC appreciates this opportunity to provide comment on the Exposure Draft of Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. If you have questions or seek amplification of our views, we would be pleased to provide whatever additional information you seek.

Sincerely,

Peter H. Knutson
Chair

Peter Lincoln
Subcommittee Chair, Internal Use Software

cc. Distribution List
Michael S. Caccese, Senior Vice President and General Counsel, AIMR
Patricia D. McQueen, CFA, Vice President, Advocacy Programs, AIMR

P.O. Box 3707
Seattle, WA 98124-2207

April 17, 1997
1-9150-05-009

Daniel Noll, Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenues of the Americas
New York, New York 10036-8775

BOEING

Dear Mr. Noll,

The Boeing Company is pleased to respond to the AICPA Proposed Statement of Position *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

The Boeing Company objects to the requirement that internal use computer software be capitalized and recognized as an asset. Listed below are our reasons for objection.

Increased complexity from capitalization of internal software
This Proposed SOP would replace a simple policy of expensing all application software with a policy that would entail the following:

- evaluating each purchase or development project for long-term benefit
- determining if there was successful implementation
- determining a value to capitalize
- determining an amortization life
- establishing an asset and amortizing the asset
- determining if the capitalized software is obsolete and the amounts of resulting impairment
- determining the impact on capitalized interest calculations

This increased complexity results in a poor cost/benefit evaluation of this Proposed SOP. The cost of doing business is raised with little or no benefit arising from the resulting disclosure change.

Furthermore, an additional administrative burden is placed upon corporations that have both commercial and government customers. The onerous task of determining how and where to book software cost increases administrative costs for little benefit. Also, it is difficult to differentiate between upgrades and maintenance and thus, is non-value added and costly because the same activity is being done; only the degree is different. Upgrades and maintenance should be expensed.

Rapid technological change
Software and computing technology is such a rapidly changing field that most equipment and software quickly become obsolete. It is not unusual for new and improved software to become available before the current application can be fully implemented. The competition in the software development industry is competitive and fast moving. Companies have developed software to meet specific requirements because no software was available in the marketplace to support those requirements. By the time the internally developed software could be tested and implemented, a similar product was available for sale at a fraction of the incurred costs.

BOEING

Further, commercial off-the-shelf (COTS) software packages become obsolete quickly and need to be updated. Most importantly, the cost of COTS software is merely a license to use the coded intelligence and does not represent an asset.

We strongly believe at a minimum, industry should retain the option to expense costs of computer software developed or obtained for internal use. While these costs are not normally material to Boeing, we believe that capitalizing these costs would overstate our asset value.

Inconsistency of accounting for other process improvements
The costs of other business process improvements are not capitalized. There is no reasonable way to capitalize the costs of ongoing business process improvements or major re-engineering efforts, such as lean manufacturing or improved asset management initiatives. Developing software to help in a business process improvement should not result in different accounting merely because software is a set of coded processes a computer executes, versus written processes people follow such as manufacturing plans or desk instructions.

Inconsistency with other accounting concepts
FASB Concept Statement No. 6 indicates that one of the characteristics of an asset is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits, which capitalized software does not. Additionally, internal use software would have little or no market value.

Uncertainty of future benefit is also the basis for prohibiting the option of capitalizing other costs, such as advertising and employee training. The similar attributes of internal use software would make capitalization an accounting anomaly.

Sincerely,

David L. Sjogren
Assistant Controller

Post Office Box 2563
Birmingham AL 35202 2563
205 325 7216

Controller

SONAT

April 17, 1997

Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Gentlemen:

Sonat Inc. (Sonat) is an integrated oil and natural gas company engaged in exploration, development and production of oil and natural gas, interstate transmission of natural gas, and natural gas and electric power marketing.

Sonat respectfully submits its views for the consideration of the American Institute of Certified Public Accountants on the Exposure Draft of the Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP).*

We support the efforts of the Accounting Standards Executive Committee (AcSEC) to achieve consistency in the accounting for computer software developed or obtained for internal use and agree with the majority of the guidance as proposed in the SOP. The one exception that Sonat has with the proposed rules is the requirement in paragraph 32 that amortization of capitalized costs would begin when the computer software is ready for its intended use. This requirement is inconsistent with the fixed asset model in which amortization begins at the time the asset is placed in service.

Attached are our responses to the specific issues you have identified in the Exposure Draft. Sonat is pleased to have had this opportunity to present our views on the issues addressed in the Exposure Draft. We will be happy to discuss our comments with the committee or its staff at its convenience.

Sincerely,

Wm L Johnson

William L. Johnson

Attachment

SONAT INC.
AICPA INVITATION TO COMMENT

ISSUE 1

Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We agree with the AcSEC that the costs of computer software developed or obtained for internal use should be recognized as assets. Computer software does provide future economic benefits to enterprises and should be reflected in their financial statements.

We do not feel that entities should have the option to capitalize or expense these costs. If the option is available, then the same issues of comparability of financial information concerning computer software between entities would still exist. Furthermore, if entities expense costs up front that have future economic benefit, the matching principle of matching expenses with the revenues they generate would be violated.

The benefits of reporting the costs of computer software developed or obtained for internal use would definitely exceed the costs of such reporting. Many entities already capitalize these costs and for those entities that do not capitalize such costs, we believe the costs of doing so would be minimal.

ISSUE 2

This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We feel that the proposed SOP is correct in not specifying a maximum period for amortization or a certain method of amortization. Due to the wide variety of computer software products available and diversity in the uses of those products, the reporting entity would be the obvious choice to determine the useful life and the methods of amortization. The guidance as proposed would also be consistent with current accounting literature regarding depreciation of the costs of fixed assets.

One inconsistency regarding amortization we feel the AcSEC should reconsider is the requirement in paragraph 32 that amortization of capitalized costs should begin when the computer software is ready for its intended use. This requirement is inconsistent with the fixed asset model in which amortization begins when the asset is placed in service.

ISSUE 3

Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

We agree that the impairment of internal-use computer software assets should be guided by SFAS No. 121. The recommended treatment will maintain consistency between recognizing and measuring impairment for internal-use computer software and for other long-lived assets. It is our view that the guidance provided for entities to recognize and measure impairment in the proposed SOP is sufficient.

ISSUE 4

This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We agree with AcSEC that an entity should not be required to meet technological feasibility criteria before it begins capitalizing qualifying costs. The technological feasibility criteria fits the inventory model but it is not adequate for determining the appropriate carrying amount for internal-use software. We believe computer software should be capitalized based on criteria appropriate for long-lived assets. Furthermore, we also agree with AcSEC that at the beginning of internal-use software projects, entities believe that technology does exist to allow completion of the software.

ISSUE 5

Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

We concur with the guidance in the proposed SOP in regards to the kinds of costs that should be capitalized.

ISSUE 6

Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

We feel that the guidance is adequate for determining whether computer software is for internal use. The characteristics provided by the proposed SOP are operational and Sonat agrees with the AcSEC decision to not include (as a characteristic of internal-use computer software) a requirement that **intent** does not exist to market the software externally.

ISSUE 7

Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP or FASB Statement No. 86, but not both? If not how should those costs be allocated?

We agree with the proposed SOP on accounting for computer software that is developed or obtained for both internal use and external marketing because it would be difficult to determine which costs were relieved when attempting to calculate the profit on the sale of the computer software.

ISSUE 8

The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

Sonat feels that the guidance as provided in the proposal is operational and can be consistently applied.

300 Atlantic Street
P.O. Box 9316
Stamford, CT 06904

Telephone 203 358 0001

Price Waterhouse LLP

April 30, 1997

Mr. Daniel Noll
Technical Manager - Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

File 4262 - Exposure Draft
Proposed Statement of Position
Accounting for the Costs of Computer Software
Developed or Obtained for Internal Use

We appreciate the opportunity to comment on the exposure draft proposed statement of position, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" (the SOP). The magnitude of many internal use software projects today, both in terms of cost and importance to enterprises, highlights the need for clear and consistent accounting treatment for these expenditures. It is not unusual for major internal use software projects at Fortune 500 companies to cost in excess of $100 million. While the size of the expenditures should not dictate the financial reporting conclusions, the magnitude does provide an indication that these expenditures can clearly be material to companies' operating results and financial positions. Computer software, today, is analogous to the bricks, mortar and heavy equipment that formed the productive backbone of many businesses during the industrial age. It is, in many instances, the engine that drives companies in the competitive, technology-based, "information age." The time is right for a consistent model to be developed for internal use software costs.

It is clear to us that expenditures made by companies to develop or obtain software for internal use represent assets as defined in the FASB Concept Statements. We, therefore, agree with the capitalization model proposed in the SOP and are supportive of final issuance of the SOP. There are, however, certain changes and clarifications that we believe should be made to the SOP that will make it more operational. Our concerns are in four main areas:

1. Maintenance versus Upgrade - While we support the capitalization model, we believe the guidance as currently drafted will not appropriately restrict the accounting "choices" available to companies in this area.

2. Impairment - The SOP cites the appropriate source of accounting literature in this area, however, we believe the application of FAS 121 guidance to internal use software assets requires additional clarification in the SOP given the nature of these expenditures.

3. Reengineering and Data Conversion Costs - These costs are often an integral aspect of comprehensive systems projects, however, are currently scoped out of the SOP. Since these services are often "bundled" with software development services and licensing fees, criteria for determining the amount to be "unbundled" will have to be developed. We believe these costs should be addressed in the SOP and, in our view, should be expensed as incurred.

4. Implementation Stage - We believe the "stages of development" guidance in paragraph 16 of the SOP is inconsistent with other guidance in the SOP and, therefore, the point at which capitalization should end is unclear. We recommend that the guidance be clarified.

Each of these four concerns are discussed in more detail below.

Maintenance versus Upgrades

Paragraphs 24 and 25 within the Conclusions portion of the SOP, and paragraphs 63 and 64 within the Basis for Conclusions, provide guidance related to distinguishing between maintenance and upgrade activities. Distinguishing between these costs is important because the SOP requires that maintenance costs be expensed and costs incurred for significant upgrades and enhancements be capitalized.

Upgrades and enhancements are defined as improvements to existing internal use software that extend the life or increase the utility (that is, functionality) of the software. This normally requires new software specifications and may require a change of all or part of the existing software specifications as well. Costs of "significant" upgrades and enhancements to internal use computer software are to be capitalized if it is probable that the expenditures will result in "significant" additional functionality or "significant" extension of the software's useful life.

As indicated in paragraphs 63 and 64 of the SOP, the definitions related to upgrades, enhancements and maintenance were basically carried forward from FASB Statement No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed" (FAS 86). It has been our experience that those definitions, in practice, have not been operational. We believe that the same operational issues will exist in the context of internal use software.

The problems currently experienced in practice relate largely to the characterization of software modification activities. The accounting treatment varies depending solely on whether the activities are thought to be "significant" or not and "significant" is in the eye of the beholder. For example, "Software Revenue Recognition" (SOP 91-1), which deferred revenue recognition when "significant" obligations remained after the delivery of software, led to diversity in the timing of revenue recognition in practice because of varying interpretations regarding what was "significant." This diversity was one of the principal reasons for the need to amend SOP 91-1. The issue of differentiating upgrades and enhancements from maintenance activities was also discussed at length in the development of the soon-to-be released SOP, "Software Revenue Recognition," which will replace SOP 91-1. In those discussions, the issue was not limited to the difference between upgrades/enhancements and maintenance, but also upgrades/enhancements compared to new products. Frankly, not much progress was achieved definitionally.

Despite the lack of progress in the "Software Revenue Recognition" project, we believe that further attempts should be made to achieve a coherent, operational distinction between upgrades/enhancements and maintenance in this project because a crisp definition is critical to differentiating between the expense or capitalization of costs. This improved definition is necessary to provide both preparers and auditors with effective guidance that will result in consistent determinations as to classification. If such a definition can not be developed we believe that the use of illustrative examples differentiating between internal use software costs incurred that should be expensed and those costs that should be capitalized will be necessary. Finally, in the absence of an operational definition or examples sufficient to demonstrate how companies should differentiate between maintenance to be expensed and upgrades to be capitalized, we believe that a rebuttable presumption should exist that all costs related to upgrades and enhancements, including implementation costs, should be expensed as incurred. This presumption may be overcome only if the upgrade or enhancement activity results in the purchase of a new software license or the development and installation of new software that computerizes previously manual systems or that completely replaces rather than modifies previous software. While an expense as incurred conclusion may not be conceptually "pure," in the absence of a workable definition we believe it will result in less financial reporting inconsistencies.

Impairment

Paragraphs 28 and 29 of the Conclusions portion of the SOP and paragraphs 72-74 in the Basis for Conclusions provide guidance related to evaluating impairment of recorded internal use software assets. The SOP specifies that internal use software assets should be subject to the impairment guidance of FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (FAS 121). We agree. Our concern is with the lack of guidance in applying FAS 121 to internal use software assets. Specifically, we do not believe it is clear from the guidance in either the SOP or in FAS 121 when and how to allocate internal use software assets to the lowest level of identifiable cash flows.

In some cases the determination of the lowest level of cash flows to which internally developed software costs should be allocated for the purpose of evaluating impairment will be relatively straightforward. For example, internal use software may be acquired or developed for implementation solely at a specific location which the company considers to be its lowest level of cash flows under FAS 121.

In many cases, however, internal use software assets will include corporate-wide software solutions, such as SAP or Oracle, which may permeate all aspects of a company's operations. The cost of the software and its implementation may have a number of pricing variations which may make it difficult to determine how to allocate the costs for impairment under FAS 121. This is because the internal use software costs are not specifically linked on a component or overall basis to division locations or other lowest level identifiable cash flows. In some cases, costs of the software may be incremental by division. In another situation, a user-based pricing scheme may be used such that the cost of the software is determined based on the number of users. In still other situations, there may be a base price plus a per user or per location cost. With respect to implementation costs, some may and some may not be specifically identifiable to each division within the corporate structure. Also, it would not be unusual for the first few implementation locations to bear disproportionately higher costs.

For these corporate-wide software solutions, and other analogous software implementations, we believe AcSEC should provide guidance as to how, or if, capitalizable costs should be allocated for purposes of evaluating impairment under FAS 121. Alternatives would appear to be:

1. No requirement to allocate costs to the lowest level of identifiable cash flows. This could take the form of either permitting such allocation or an express preclusion from doing so.

2. A requirement or permission to allocate costs to the lowest level of identifiable cash flows based on the direct and incremental costs attributable to such locations with the remainder recorded at the corporate level.

3. A requirement or permission to allocate costs to the lowest level of identifiable cash flows based on any consistently applied and reasonable methodology.

It is our belief that alternative #2, as a requirement, is the appropriate conclusion. We also suggest that AcSEC consider providing examples in the SOP illustrating how the final allocation methodology for impairment determination is to be applied.

Reengineering and Data Conversion Costs

Paragraph 10 of the SOP states that accounting for the costs of reengineering operations associated with new or upgraded software applications and accounting for costs of converting data from old systems to new systems are excluded from the scope of the SOP. The SOP neither addresses the accounting for these costs nor defines them in a manner which would allow preparers and auditors to consistently distinguish between these costs and internal use software costs. We believe that such costs should be included in the scope of the SOP due to the fact that they typically represent a significant percentage of the costs that are incurred in comprehensive systems projects today. The SOP should distinguish between reengineering, data conversion and internal use software development costs and provide guidance on accounting for reengineering and data conversion costs. Since these services are often "bundled" with software development services and licensing fees, similar to training and maintenance costs discussed in paragraph 27 of the SOP, criteria for determining the amount to "unbundle" will have to be developed. We believe that any allocations done to "unbundle" such services should be done on the basis of the fair value of the services received, regardless of whether the related costs are specified in the contract or not.

We believe that reengineering and data conversion costs should be expensed as incurred as they do not represent direct costs of creating the internal use software. Reengineering costs are often incurred for reasons similar to restructuring costs. Restructuring and other costs to improve the efficiency of operations, which do not represent the exiting of activities under EITF Issue No. 94-3, are treated as period costs although they are clearly incurred with the intent of benefiting future periods. We believe that reengineering costs should be treated in a similar manner. With respect to data conversion costs, the costs of building original databases (which may need to be converted when new software is developed) are expensed as incurred, as are the ongoing maintenance costs of the databases. We believe that data conversion costs should be treated similarly. Regardless of whether AcSEC agrees with our views on these matters, the SOP needs to provide additional guidance on differentiating such costs from internal use software development costs since the accounting treatments under the currently drafted SOP may be different.

Implementation Stage

The chart included in paragraph 16 of the SOP outlines three stages of computer software development; preliminary project stage, program instruction stage and implementation stage. As outlined in paragraphs 17 through 21 of the SOP, capitalization of costs cannot begin until after the preliminary project stage is completed. It is unclear, however, when the capitalization of costs should cease, specifically whether implementation activities are to be included in capitalized costs. Paragraph 23 of the SOP indicates that capitalization should cease when the computer software is ready for its intended use, defined to be a period after substantially all testing is completed. Testing is the last activity listed under the program instruction stage in paragraph 16. This would seem to imply that all implementation activities are either outside the scope of the SOP or that they should be expensed as incurred. We disagree with this inference. For this reason we would prefer that paragraph 16 be deleted.

We believe that if paragraph 16 remains in the SOP, further explanation should be given as to what activities comprise the "implementation stage," how these activities should be evaluated, and whether those activities should or should not be capitalized. Additionally, if AcSEC's conclusion is that implementation costs should be expensed as incurred, guidance should be provided as to how to unbundle the capitalizable portion of a single contract that includes a software license, customization and modification related to installation, and actual installation. If the conclusion is that implementation costs are included within the scope of the SOP and should be capitalized, AcSEC should differentiate these costs from reengineering and data conversion costs, as discussed above.

Other Comments

The SOP provides guidance in paragraph 26 regarding the types of costs that would be capitalizable as internal use software. We believe that the Conclusions section of the SOP should clarify that external direct costs would include travel expenses incurred by employees in their duties directly associated with developing internal use software. The SOP also should clarify that payroll and payroll-related costs should include costs of all employees involved with the development of internal use software, such as internal users of the software who participate in the testing phase of the software (as opposed to training).

The SOP specifies in paragraph 27 that when training or maintenance fees are not specified in the contracts, entities should allocate the cost among training, maintenance and amounts representing the capitalizable costs of computer software. We believe the SOP should explicitly state that such allocations should be done on the basis of the fair value of the services and software received, regardless of whether the related costs are specified in the contract or not. Evidence of fair value might be determined based upon bids received with and without training and maintenance fees included as part of a bundled package, or based on the proportional hours of effort expended by the vendor.

We believe that each module or component of software should start being amortized when it is ready for its intended use and it is not dependent on other, uncompleted modules or components, to properly function. While we understand that this was likely the intent of AcSEC, it is not explicitly clear from the guidance provided in paragraph 32 of the SOP.

While we agree with the concept outlined in paragraph 33 of the SOP, we believe the proceeds received from the sale of computer software originally developed or obtained for internal use should be net of direct related costs of sales and selling costs prior to application against the carrying amount of the software. Direct costs of sales and selling costs should exclude period costs such as sales force salaries, however, would include incremental amounts such as sales commissions, software reproduction costs, warranty and service commitments, and installation costs.

Significant upgrades and enhancements of current software may go through some form of a preliminary project stage similar to the development of new software. We believe the SOP should be clear that the costs of such efforts in connection with the development of significant upgrades must also be expensed.

The SOP should specifically address the treatment of the costs of post-contract customer support (PCS) arrangements entered into between licensees and software vendors. These PCS arrangements may result in significant upgrades and enhancements. Nevertheless, because the upgrades and enhancements are unspecified at the inception of the PCS arrangement, we believe the SOP should specifically exclude the capitalization of any fees related to PCS arrangements.

Prototyping is an activity frequently carried out in the software development process. We believe the SOP should describe whether prototyping is part of the preliminary project stage. We note that the description of research and development activities in paragraph 9 of FASB Statement No. 2, "Accounting for Research and Development Costs," seems to suggest that prototyping activities are research and development.

As outlined in paragraph 34 of the SOP, no new disclosures have been required as part of this guidance. Given the magnitude and nature of these expenditures, and the fact that inconsistent treatment of internal use software expenditures prior to the adoption of this SOP will carry forward in companies' financial statements, AcSEC should reconsider whether companies should be required to disclose the total annual amount of internal use software costs capitalized and the amount of such assets at each balance sheet date.

<u>Specific Issues Requiring Attention by Respondents</u>

The following responses address the specific issues for which AcSEC had requested feedback in the exposure draft:

(1) Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We agree that the costs of computer software developed for internal use represent assets, as defined in paragraphs 25 and 26 of Statement of Financial Accounting Concepts No. 6, and should therefore be recognized as such. We do not believe that entities should have the option to account for similar costs in a dissimilar manner. This would not improve the relevance and consistency of financial reporting in the area of internal use software. We believe that the benefits of reporting the costs of computer software developed for internal use exceed the costs. The reporting costs are similar in nature to those for tracking internally constructed fixed assets and generally should not be significant.

(2) This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We agree with AcSEC's conclusion that it is not appropriate to specify a maximum period for amortization or method of amortization. Internal use software is developed to benefit one specific enterprise and is generally not as vulnerable to changes in technology and other market forces in triggering obsolescence as is software to be sold, leased or otherwise marketed. We believe it is inappropriate to specify maximum useful lives in the absence of specific facts. Rather, each company should determine the most appropriate period and method of amortization based upon the specific characteristics of its software and the intended use of the software by the company.

(3) Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of?* If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

See our area of concern discussed on page 3 of this letter.

(4) This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We support the SOP's guidance as it relates to technological feasibility and research and development, as outline in paragraphs 44 through 49 of the SOP. However, because of the difference in capitalization models which will exist between costs of internal use software and costs of software to be sold, leased or otherwise marketed, we believe that the SOP should address how to account for costs capitalized prior to technological feasibility under this SOP when, later in the development phase, an enterprise adopts a plan to market the software externally.

(5) Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

Other than as discussed in the forepart of our comment letter, we support the SOP's guidance related to capitalizable costs, and specifically the exclusion of general and administrative, overhead and training costs from such costs. We believe these costs are properly treated as period expenses.

(6) Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

We believe the guidance provided by the SOP in distinguishing between internal use software and software to be sold, leased or otherwise marketed is an improvement over the guidance provided in the February 1986 FASB Highlights article and will result in consistency in practice. The examples included in the document are useful in ascertaining the intended distinctions between internal and external use software.

(7) Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

We agree with the guidance proposed in the SOP. We believe that it is impractical to bifurcate the costs of developing software between costs incurred related to internal use applications and costs incurred for software to be sold, leased or otherwise marketed. Any such allocation of costs would be arbitrary at best. We also support the cost recovery model proposed in the SOP (modified as discussed under the "Other Comments" section of this letter) to account for internal use software that is subsequently sold, leased or otherwise marketed after the development stage. The SOP model appropriately discourages companies from capitalizing costs under the internal use software model in an effort to avoid the technological feasibility requirement of FAS 86.

(8) The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

See our area of concern discussed on page 2 of this letter.

* *

We will be pleased to discuss further the matters raised in this letter. Should you wish to do so, please contact David B. Kaplan at (203) 316-5745.

Very truly yours,

Price Waterhouse LLP

Price Waterhouse LLP

R C Oelkers
Comptroller

Texaco Inc

2000 Westchester Avenue
White Plains NY 10650

April 24, 1997

Daniel Noll, Technical Manager
Accounting Standards Division, File 4262
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Noll:

Texaco supports the adoption of the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.* We believe it adequately fills the current vacuum in authoritative literature regarding this issue. Its adoption will eliminate current inconsistencies in accounting practice and will enhance comparability of financial statements amongst entities. Following are Texaco's comments regarding the proposal:

Recognition as Assets

Texaco agrees with the view that costs of computer software developed or obtained for internal use should be recognized as assets, excluding costs related to research and development. We concur with the notion that entities incur such costs to achieve benefits similar to those achieved by incurring costs for other long-lived assets. Examples of such benefits include reduced go-forward costs, greater operating efficiency, improved internal controls, better customer service, and gains in competitive advantage.

Furthermore, from a conceptual viewpoint, FASB Concepts Statement No. 6 supports the recognition of internal-use software costs as an asset. In Texaco's opinion, such costs have the essential characteristics of an asset as described in paragraph 26 of that Concepts Statement. Such costs embody future benefits (described above) which will enhance future cash flows. By incurring such costs, entities obtain benefits and may control others' access to them. Also, the transaction or other event giving rise to an entity's control of such benefits has already occurred.

Texaco shares AcSEC's view that incurred costs for internal-use software are specifically identifiable. In our opinion, the useful life of any such recognized software asset is determinate. Such life is as capable of reasonable estimation as are the useful lives of long-lived assets. Therefore, Texaco agrees with the view that such software costs should receive accounting treatment as long-lived assets.

To achieve maximum comparability between financial statements of all entities, Texaco urges that the final SOP provide uniform accounting handling of all costs that meet the definition of internal-use software costs. Accordingly, Texaco opposes any provision in a final standard that would provide an alternative option to expense such costs.

In Texaco's opinion, the benefits from recognizing internal-use software costs as assets would exceed the costs of such accounting. Adoption of this proposal will lead to the achievement of a better matching of the benefits derived from using software (described above) with the costs of such software. Also, better comparability of financial statements amongst entities would surely result from entities following a single rule. Texaco believes that any resulting incremental costs of achieving these benefits would be insignificant. It is likely that most companies would utilize existing computer systems that account for other long-lived assets, rather than develop or obtain new costly programs to handle accounting for software assets. Furthermore, we believe entities would limit application of this rule to software costs that are material: entities would charge immaterial costs to expense as incurred. Such materiality thresholds would result in the application of this SOP to a limited number of projects. Thus, costs of applying the proposed SOP would be minimized.

Amortization

Texaco believes that this SOP should limit the amortization period for capitalized internal-use software costs to five years. In this age of quickly changing technology, we believe that useful life estimates greater than five years would necessarily be too subjective. While Texaco opposes mandating a particular method of amortizing these costs, we recommend that the SOP require use of the "straight-line method" unless it can be shown that some other method better attributes capitalized costs to the periods benefited. In our view, each software package is unique. Because of this uniqueness, we believe that each entity incurring such software costs is in the best position to estimate the most appropriate amortization period and method within the above guidelines. Thus, Texaco favors providing entities with limited flexibility to determine the amortization period and method for these costs.

Impairment Recognition and Measurement

Texaco sees no reason to provide a special exemption for capitalized software costs from FAS No. 121 "*Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*". Since this proposal views internal-use software costs as long-lived assets, FAS No. 121 should be applied to these costs for the sake of consistency.

From Texaco's viewpoint, the proposed SOP contains sufficient guidance for entities to recognize and measure impairment of capitalized software assets. In Texaco's opinion, two events would most likely trigger the need for an impairment evaluation. A significant change in the extent or manner in which the software is used would be one such event. The second most likely trigger event would be the accumulation of capitalized software costs significantly in excess of the amount originally expected. Both of these cases are included in the guidance provided in the proposed SOP. Furthermore, Texaco agrees that uncompleted internal-use software assets are likely to have a zero fair value. Until software works as intended, it has no value in Texaco's opinion.

Requirement to Meet Technological Feasibility Criteria

Under FAS No. 86, the establishment of technological feasibility is defined as part of the research and development stage in the case of software for external sale. Texaco believes that for internal-use software, the research and development stage is less comprehensive, and therefore does not necessarily encompass the complete demonstration of technological feasibility before capitalization of costs should commence. In the case of internal-use software costs related to activities other than research and development, Texaco would oppose any requirement to meet technological feasibility criteria before starting capitalization.. Similar criteria are provided in paragraph 4 of FASB Statement No. *86 "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed"*. We agree with the view that the development risks associated with creating internal-use software are conceptually no different from the development risks associated with creating other long-lived assets. In both instances, entities develop assets that provide future benefits. Also, Texaco supports the consistent application of accounting principles related to other long-lived assets that contain no such feasibility criteria to capitalized internal-use software costs.

The technological feasibility criteria applied in FAS No. 86 to software that is to be sold, leased or otherwise marketed are appropriate to an inventory model. That inventory model implicitly includes a marketability test, a notion that is not applicable to internal-use software. In the long-lived asset model being used for internal-use software, entities defer costs and attribute them to the future periods that benefit from using the asset (software).

Kinds of Costs Capitalized

Texaco agrees with the view that general overhead and administrative expense should be excluded from the measurement of software assets. We recognize that an allocable portion of such expense theoretically may be part of the overall cost of software assets. However, Texaco believes that any such allocation would necessarily be arbitrarily determined, too imprecise, and inconsistently applied amongst different entities. In our opinion, the benefits resulting from such allocations would not be worthwhile. Texaco also agrees that maintenance and training costs should always be charged to expense.

Texaco also concurs with the description of the types of direct software costs that should be capitalized. We agree that interest costs incurred during the development of internal-use computer software should be capitalized for the sake of theoretical consistency with FAS No. *34 "Capitalization of Interest Cost"* that applies to other long-lived assets. In our opinion, such interest cost allocations will be made only for material amounts - immaterial amounts will be ignored. Therefore, we believe the incremental costs of such interest capitalization will be minimal.

Guidance to Determine Software is for Internal Use

In Texaco's opinion, guidance provided in paragraph 11-15 of this proposed SOP is sufficient to help entities determine whether or not computer software is for internal use. No situations come to mind which would not be covered by such guidelines.

Software Developed or Obtained for Dual Purposes

Texaco supports the approach in this proposal that requires an entity to measure software costs at the project level. We also agree that accounting guidance in either this proposed SOP or FAS No. 86 should be followed depending upon the use of the software, but not both. In our opinion, it would not be meaningful to require allocation of costs between software for internal-use and software to be sold, leased or otherwise marketed. By necessity such allocations would be imprecise, arbitrary, and inconsistently applied amongst entities. While such allocation may be theoretically justified, it would be impractical to apply.

Guidance to Distinguish Upgrades or Enhancements from Maintenance

Texaco believes that guidelines to distinguish between software upgrades or enhancements, and, software maintenance should be similar to guidelines that distinguish improvements to other long-lived assets from maintenance of such other long-lived assets. This proposal defines software upgrade and enhancement activities as those which extend the life or increase the utility of software. Such upgrades and enhancements usually require a change in all or part of the existing software specifications. We believe these guidelines are sufficiently consistent with the guidelines for recognizing improvement activities related to other long-lived assets. Accordingly, we believe that the guidelines in this proposed SOP are adequate and operational. We concur with the AcSEC's decision to make the definitions of upgrades, enhancements, and maintenance activities in this SOP consistent with those contained in FAS No. 86.

Texaco appreciates the opportunity to comment on this proposal.

Very truly yours,

RC Oelkers

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GM

General Motors Corporation

May 2, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File Reference No. 4262: Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

Dear Mr. Noll:

We appreciate the opportunity to respond to the Proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Expenditures for internal use software have increased significantly over the past several years, and without authoritative guidance on this subject, diversity in recording these costs has also increased. Not only does this diversity exist between entities, but also within entities. As such, we agree that authoritative guidance is necessary to help minimize the inconsistencies that currently exist.

We believe that internal use computer software should be capitalized as assets, as it has the three essential characteristics of an asset based on FASB Concepts Statement No. 6: "(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." Entities should not be given the option to capitalize or expense such costs; if this option exists then guidance would not be necessary, as diversity in practice would continue. In addition, each entity will continue to have the ability to apply its own materiality thresholds for purposes of adopting the SOP.

To be consistent with the recognition and measurement of impairment for other long-lived assets, we support the use of SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* for internal use software assets. We believe the proposed SOP adequately addresses this issue.

The proposed SOP indicates that costs that should be capitalized include external direct costs of materials and services, interest costs incurred while developing the software, and payroll and payroll-related costs for employees who are directly associated with the project. These types of costs are all capitalized for other self-constructed assets, and for consistency should also be capitalized for internal-use software. However, internal payroll and payroll-related costs can be interpreted differently in terms of calculating the personnel costs related to each project, by considering which functions are "directly" associated with the project (e.g. PC support, etc.) and determining which costs are considered "payroll-related" (e.g. pension costs, healthcare costs, etc.). In the final SOP, more detailed guidance should be given in this area to avoid confusion, diversity, and abuse of the types of costs capitalized.

The SOP should not state a maximum amortization period or require certain methods of amortization. Amortization periods should be determined on a product-by-product basis, as useful lives will vary. Amortization methods should also be determined by each entity, consistent with the requirements for other fixed assets.

In summary, we agree with the general direction of the SOP. The costs of reporting could be significant, as software will have to be added to the applicable fixed asset systems, accounts will have to be assigned, and the recording and subsequent amortization will have to be tracked. However, it is difficult to deny conceptually that internal-use software does not create a probable future benefit to an entity, and should therefore be recognized as such.

If you have any questions or wish to discuss this matter further, please contact me at (313) 556-4167.

Sincerely,

Peter R. Bible
Chief Accounting Officer

Gary A. Swords
Vice President
Chief Accounting Officer

CIGNA

May 2, 1997

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Mr. Daniel Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

CIGNA Corporation is pleased to comment on the proposed Statement of Position (SOP) entitled *"Accounting for the Cost Of Computer Software Developed or Obtained for Internal Use."* In general, CIGNA supports the provisions of the proposed SOP to capitalize external costs incurred to develop software for internal use if the period of future economic benefit can be reasonably determined. However, we do not support the requirement to capitalize internal costs of software development as discussed below. In addition, we believe the proposed effective date for 1998 financial statement is not feasible, considering the cost accumulation and tracking systems that will be needed to comply with the proposed SOP. Our specific comments concerning these and other issues follow.

Internal Cost Capitalization: CIGNA along with many other companies, has chosen to expense internal software costs because they are fixed costs. Such costs can be distinguished from external software costs because internal costs are generally ongoing costs. A company's internal systems costs and resources are generally consistent from period to period (on a normalized basis) and are usually deployed on a varied mix of development, enhancement, or maintenance projects. On the other hand, external costs to develop software for internal use can be readily and specifically identified for software development, and are clearly incremental. We believe that internal costs should be treated as period costs unless they are clearly incremental, and the related period of future economic benefit can be reasonably determined.

Alternatively, we recommend that the proposed SOP permit the capitalization of internal software development costs rather than require such capitalization. While we understand that the objective of this proposed SOP was to reduce the diversity of practice in this area, we do not believe that the benefits of additional financial information or reduced diversity in practice outweigh the related costs to develop and monitor a system to track and report internal development costs, particularly internal costs such as payroll and benefits.

Implementation for 1998 Financial Statements: We believe it is not feasible to meet the proposed effective date due to the expected systems changes that would be needed to properly track and control company-wide accumulation, amortization and reporting processes. Many entities have already allocated development resources for 1997 that will be strained to comply with the SEC's market risk disclosure requirements and to implement Year 2000 enhancements. Therefore, the resources and time are not available to develop such systems to implement the proposed SOP. We believe the effective date should be delayed to years beginning after December 15, 1998.

Costs to Capitalize: The proposed SOP does not address the costs of converting data from an existing system to a new one, nor does it address the costs of installing a purchased or developed internal-use system. Because these costs are essential in preparing the new system for its intended use, we believe that if development costs are required to be capitalized, costs of placing the system and data in use should also be included in the capitalized asset, similar to such costs for furniture or equipment. Without system installation and data conversion, there is little future economic benefit to systems software.

Although this response has been delayed beyond the SOP's comment date, because of first quarter reporting activities, I hope that these comments will be considered in determining final guidance in accounting for costs incurred to develop software for internal use. Please call if you have any questions or would like to discuss these views.

Very truly yours,

Gary A. Swords

Gary A. Swords

softwre1.cst

J. Michael Kelly
Senior Vice President - Finance

GTE Corporation

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203 965-2000

April 30, 1997

Mr. Daniel Noll
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Dear Mr. Noll:

GTE, as both preparer and user of financial statements, is pleased to have the opportunity to comment on the AICPA's proposed statement of position, *Accounting for the Costs Of Software Developed or Obtained for Internal Use* (the "SOP"). With revenues of more than $21 billion in 1996, GTE is one of the largest publicly held telecommunications companies in the world. In the United States, GTE offers local and wireless service in 29 states and long-distance service in all 50 states. Outside the United States, where GTE has operated for more than 40 years, the company serves over 6.5 million customers. GTE is also a leader in government and defense communications systems and equipment, directories and telecommunications-based information services, and aircraft-passenger telecommunications.

In general, GTE is concerned that the exposure draft is too broad in its requirement that all software costs (internally developed and purchased) be capitalized and amortized over an arbitrarily determined life. We strongly believe that a distinction should be made between operating software which is utilized to operate and support the communications network and software which supports general and administrative activities. Flexibility then should be provided to companies giving them the ability to expense operating software as is done in current practice by all companies in the telecommunications industry. Such an option will enable regulated entities to report consistent financial information for external reporting purposes and for regulatory purposes and eliminate the need for duplicate recordkeeping that would otherwise be required. This view, as well as other issues of a lesser concern are explained further in the attached responses to the questions included in the SOP.

We appreciate the opportunity to express GTE's views and hope that these views will be helpful to the AICPA in its deliberations. If you have any questions or require any additional information please do not hesitate to contact Mike Morrell at (203) 965-3281.

Very truly yours,

J. Michael Kelly

JMK:co

GTE CORPORATION
RESPONSE TO PROPOSED STATEMENT OF POSITION
"ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE"

Issue 1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

The cost of computer software developed or obtained for internal use should be recognized as an asset, if (a) the individual facts and circumstances suggest that such costs meet a clear definition of a long-lived asset and (b) the benefits of such reporting exceed the associated cost. We do not believe that the SOP, as drafted, provides sufficient guidance for determining whether these two criteria have been met in all cases.

The SOP is based on the presumption that all internal use software spending meets the definition of a long-lived asset because such spending is presumed to result in future economic benefit. We believe that the same can be said for the advertising and other marketing costs incurred to launch a new product or service supported by such software. Nevertheless, generally accepted accounting principles require that advertising and marketing costs be expensed as incurred due to the uncertainties associated with realizing the intended future economic benefit. In our view, the long-term benefits associated with many (but not all) types of software spending are equally uncertain. In fact, the pace of technological change has resulted in situations where the useful life of certain computer hardware is now measured in months rather than years. To capitalize and amortize the constantly changing software spending associated with such hardware seems counter-intuitive. As a result, we believe that a broad standard requiring across-the-board capitalization of internal use software without further guidance as to a means for measuring future economic benefit is, in certain cases, inappropriate. Without further guidance of this sort, entities should continue to have the option of capitalizing or expensing software spending based on individual facts and circumstances.

GTE's primary business is telecommunications. To provide telecommunications services to its customers, GTE employs a wide range of software with diverse characteristics in its voice, video and data networks. Like most other large companies, GTE also utilizes software extensively for general and administrative (G&A) functions such as billing, finance and accounting, accounts payable and payroll.

We believe that in our industry we currently have consistency and comparability as it relates to accounting for software. Companies routinely expense network operating software that is utilized to operate and support the communication networks. As you may be aware, when the Federal Communications Commission (FCC) adopted its new Part 32 accounting rules it was the first time it incorporated US GAAP to the extent regulatory considerations would permit. The FCC initially proposed accounting treatment for software similar to that which is proposed in the SOP.

After much time spent analyzing and evaluating the business, operational and economic ramifications of its proposal, the FCC revised its proposal and now requires the expensing of all software costs other than initial operating system software. One of the points raised by AT&T in 1985 was that "technological advances are preceding at an explosive pace." This was true then, and it is clearly true now.

Conceptually, we strongly believe that companies should continue to have the option to expense all software. However, if a distinction must be made, then we argue that network software should be excluded from the SOP, as we do not have ownership rights to the software used on our network, and this type of software has a relatively short life, sometimes even less than twelve months. G&A type software, on the other hand, has a different set of facts and circumstances regarding its useful life.

In general, GTE believes that the accounting proposed in the SOP is appropriate for the G&A type software referred to above albeit for reasons different that those set out in the SOP. In our experience, these types of software can have a life greater than one year due to the cost and complexity of changing them. As a result, GTE's present practice of expensing such costs as incurred can have a significant effect on the year-to-year comparability of financial results at the time that such systems are replaced. We believe that the SOP will appropriately minimize this potential effect.

The characteristics of GTE's network software, however, are considerably more complex and less appropriate to the broad capitalization standard proposed in the SOP. Network software is changed constantly and for a variety of reasons. Software is installed in the network to expand GTE's service offerings with the intent of increasing revenues. Software is also installed to improve network quality which may or may not increase revenues. In some instances, software is installed to meet regulatory requirements that do not increase revenues and in other instances software is installed in GTE's network to combat fraud and minimize the loss of revenues. Each of these spending decisions is based on different economic considerations and useful life assumptions. The useful life for each piece of software is not only relatively short but highly unpredictable. However, in our view, all of these assumptions are relevant to determining the appropriate accounting treatment for such costs. We are particularly concerned that the reference to telecommunications software in Item 8 to Appendix A will result in the inappropriate assumption that each of these spending decisions should be assessed and accounted for in an identical manner. As a result, we believe that this reference in Item 8 to Appendix A should be deleted from the final statement.

In addition to the economic considerations discussed above, in the case of regulated telecommunications companies, we are not convinced that, the benefits of the accounting proposed in the SOP for network software justify the costs.

Over the last few years, based on actual and anticipated changes in the level of competition, GTE and other major telecommunications companies discontinued using regulatory accounting practices for external reporting purposes. Despite this change, until such a time as the anticipated level of increased competition is achieved to the satisfaction of lawmakers and regulators, GTE will remain subject to a wide range of regulatory accounting requirements at the federal level and in each of the individual states in which it operates. At present, the accounting required by each of these regulatory entities is acceptable under GAAP. This may no longer be the case if the proposed SOP is implemented as drafted and, as a result, GTE will be required to keep dual records for its software spending. Although this will not be the only case in which dual recordkeeping is required as the result of the regulatory process, the volume and frequency of changes to network software and its relatively short useful life make it difficult to conclude that the cost of keeping dual records will result in any meaningful and lasting benefit to financial statement users. This is particularly the case since the annual spending for network related software is reasonably consistent and, over-time, the amount of software being capitalized and amortized will approximate one another.

In summary, it is GTE's view that all internal use software (other than initial operating software) should continue to be expensed as the estimated life of software is extremely arbitrary, capitalizing will yield little benefit in relation to the cost of administering the record keeping and consistency among companies within specific industries will be compromised. In any event, however, due to the reasons cited above, a clear distinction should and must be made between operating, or network, software and G&A software, with the former being expensed under any scenario.

Issue 2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

This issue relates back to question one. Provided that there is further guidance as to measuring future economic benefit, the prescribed amortization period should have a maximum of five years. The guidance as to measuring future economic benefit within the range of zero to five years should include considerations that, by their nature, provide inherent limitations to what is and what is not an acceptable amortization period.

For simplicity, we believe that straight-line amortization should be required.

Issue 3: Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

Conceptually, we agree that impairment of internal use computer software should be recognized and measured in accordance with FASB Statement No. 121. However, we question whether there is a meaningful way to measure cash flows for each separate software product that an entity may have installed. As a result, GTE does not believe that the impairment standards of FASB Statement 121 should or could be consistently applied.

Issue 4: **This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*) before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing costs of computer software developed or obtained for internal use? If so, what are those criteria?**

All internally developed software has a certain degree of risk and these risks may be essentially equal whether software is developed for external use or for internal use. Yet, the standards for capitalization are different between the SOP and SFAS 86. We believe that the criteria for capitalization should be the same for all software, regardless of whether it is intended for external or internal use.

Issue 5: **Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?**

Although we believe that the SOP should provide broad rather than narrow guidance as to the type of costs that should be capitalized, as written, the SOP is somewhat vague. In our view, provided that future economic benefit can be measured, capitalized costs should include all separately identifiable and incremental costs associated with the project. This would include:

- outside consultants fees;
- internal salaries and benefits for employees dedicated to the project (including administrators as well as programmers);
- occupancy costs for dedicated development facilities that are incremental to normal company operations;
- training related costs for programmers and other employees directly involved in the development effort; and
- travel costs.

Issue 6: **Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?**

Although, the guidance provided in paragraphs 38-43 and the examples included in Appendix A are sufficient for guidance for determining whether software is for internal use, we do not believe that they provide sufficient guidance as to which, if any, of these examples is illustrative of a situation where future economic benefit is probable.

As discussed in question 1, in our view, the decision as to which software costs are capitalized or expensed should be based on whether individual facts and circumstances suggest that such costs meet a clear definition of long-lived assets and whether the benefits of the recordkeeping required justifies the associated cost.

Issue 7: **Software is sometimes developed or obtained for both internal and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software relate to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?**

Yes. We agree with the SOP's approach that requires each software development project to be accounted for using either the provisions of the proposed SOP or FAS Statement No. 86 but, not both.

Issue 8: **The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?**

Although conceptually sound, the practical application of the guidance provided in the SOP is questionable in certain circumstances.. A new release of software will often include both enhancements and maintenance type changes. In many cases these costs are not separately identifiable and any allocation would be arbitrary.

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May 5, 1997

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Grant Thornton
GRANT THORNTON LLP Accountants and Management Consultants
The U.S. Member Firm of Grant Thornton International

Dear Mr. Noll:

We appreciate the opportunity to comment on the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

We commend the efforts of the Accounting Standards Executive Committee in developing guidance on this issue, which has increasing significance for most entities. We support the overall conclusion presented in the proposed SOP that specified costs incurred in developing or acquiring software to be used internally should be capitalized as fixed assets, once the R&D phase of the project is completed. We have, however, comments and recommendations on aspects of the conclusions, which are discussed below.

Capitalization

We concur that the cost of computer software developed or purchased for internal use should be recognized as an asset, and to facilitate comparisons among entities, entities should not have the option to capitalize or expense such costs.

Theoretically, capitalized costs should not significantly exceed the cost of purchasing the software externally. This is particularly a concern for internal costs, but may also apply to external costs. We recommend that AcSEC consider including a provision that capitalization of costs cease if it is determined that costs incurred to date exceed the cost of purchasing the software externally.

In the section "Capitalize or Expense," it would be helpful guidance to state that if capitalization began and then, because of difficulties encountered or new information about other approaches, management changed paths and began development on a different path, that costs capitalized on the original project should be expensed. Management had not, in fact, completed the preliminary project stage when it began capitalizing costs.

We agree that the benefits of capitalizing specified costs of developing or acquiring software for internal use would exceed the costs, which are essentially the following record keeping costs:

- capturing external costs and categorizing them as R&D, costs of program instruction, implementation, post-contract support, training, maintenance, upgrade/enhancements, etc.
- maintaining a project management system for internal costs to determine if the costs are part of the project, the phase of the project they relate to, and whether they should be capitalized or expensed
- maintaining information for interest capitalization
- maintaining fixed asset and amortization records
- testing for impairment when appropriate.

Amortization

Although specifying any maximum amortization period would be arbitrary, the guidance in paragraph 31 would be more effective if it included a presumption, or at least an observation, that the life should be short (because of the factors listed at the end of the first sentence).

Impairment

The guidance about following SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, is useful and should be retained. This applies particularly to paragraph 29, which clarifies that a project that will not be completed and placed in service should not be accounted for under the impairment provisions of SFAS 121, but under the SFAS 121 provisions for fixed assets to be disposed of. To highlight the fact that this section addresses both impairments and disposals/abandonments, we suggest changing the section title to "Impairment and Uncompleted Projects."

Paragraph 29 would be clearer if the sentence "The rebuttable presumption is that such uncompleted software has a zero fair value" were moved to follow the bulleted list.

Costs to Be Capitalized

Paragraph 16 presents a clear schematic of the stages of software development (preliminary project stage, program instruction stage, implementation stage), and paragraphs 19-23 address what costs are to be capitalized. Those paragraphs explicitly provide that capitalization does not begin until after the *preliminary project stage* is complete. It is clear from the context of those paragraphs the costs incurred in the *program instruction stage* are capitalized. Whether costs incurred in the *implementation stage* are capitalized is not explicitly stated, nor is it clear from the context.

It would be helpful if the language in paragraph 21 was more explicit. It now says that after the preliminary project stage, a project proceeds to the program instruction and implementation stages, during which an entity "is likely to" design, code, and implement the software. Is the meaning that these are the costs that should be capitalized? Paragraph 21 is a key paragraph in the proposed SOP that specifies the capitalizable costs. It should explicitly state in the terms of the stages identified in paragraph 16 what can be capitalized. Is it costs incurred in both the program instruction stage and the implementation stage, or only program instruction stage costs? Paragraph 23 states that capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. Does implementation occur before or after the software is ready for its intended use?

The proposed SOP provides no definition or discussion of software implementation. It is a broad concept and is likely to be interpreted more or less broadly by different entities if no additional guidance is provided. As used in the proposed SOP, is *implementation* meant to include installation of the software throughout the entity, configuring it based on the hardware at each location, testing it in the company's environment, the cost of running parallel systems? The proposed SOP would be clearer and consistency in its application improved if a definition and/or examples of the intended meaning of implementation was provided.

Paragraph 19 implies that all software development costs that are not R&D costs can be capitalized. It should either be modified to state that *certain* costs of internal-use computer software should be capitalized or cross referenced to paragraph 26 for costs that can be capitalized.

Paragraph 26 specifies costs that can be capitalized. Because of the narrow scope of the examples in the first two bullets, it is not clear whether, for example, travel costs incurred by employees in working on an internal software development project could be capitalized. Clearly travel costs for outside consultants would be capitalized, and it does not seem appropriate to determine capitalizable costs based on whether they are incurred by an employee or a consultant. Also, it is not clear whether the payroll costs of employees devoting significant time to the software project in capacities other than as software specialists (for example, an accountant working with a programmer to explain how certain computations should be made) can be capitalized. A few additional examples in those two bullets could clarify the implementation of the proposed SOP.

Determining if Software Is for Internal Use

The examples in Appendix A illustrating when computer software is for internal use are helpful in clarifying the intent of paragraph 42 and should promote consistent application of the proposed SOP.

However, there seems to be an increasingly important situation that is not addressed in the examples. We suggest addition of one or more examples that clarify whether software that gives customers access to an entity's services or products is internal use software. In effect, it may be software similar to that in a bank's automated teller machine (ATM), but is available to customers in situations such as the following:

- as a remote terminal (ATM) on the customers' premises as long as they remain customers (of the bank) or subscribers (for example, to an online financial news service)
- on the Internet, for example if the computerized catalog in Appendix A, example 16, is not sold to customers, but is put on the vendor's website so that customers can order over the Internet
- on their own computer systems, for example, software giving access to the broker-dealers' database in example 10.

Software for Internal Use and for Sale

We agree with the Exposure Draft's concept that software should either be for internal use or for sale. However, the guidance should result in accounting for the substance of the transaction, and this could be better accomplished by deleting the work *solely* from paragraph 11. A software project would continue to be accounted for as internal-use software only if two tests were met:

- the software is developed to meet the entity's internal needs
- no plan exists to market the software externally.

Omitting the word *solely* would avoid situations in which entities have historically been able to recoup a small portion of their cost of developing software to meet their own needs through, for example, sales to other entities in their region in the same line of business. If such incidental sales caused the entity not to be able to account for the software as internal use, it would prevent accounting for the substance of the transaction. Deletion of *solely* would not change the effectiveness of the two tests, but would make it more possible to conclude that efforts to recoup part of the cost of developing the software do not preclude accounting for it as internal use software.

We presume the intention of paragraph 11 is to limit use of the accounting for internal-use software to projects that an entity does not plan to market. The second bullet states that "no plan exists to market the software." However, the next sentence describes a plan that is quite developed: "a selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities." The paragraph could be understood to mean that if a fairly extensive marketing planning program is not in process during the period the software is developed, the software could be accounted for as internal use. We would suggest rewording the second bullet to say "During the software's development or modification, the entity has no plans to market the software" and deleting the first sentence following the bulleted list.

Disclosure

We recommend that the proposed SOP require the following disclosures:

- the estimated total project cost
- the amount capitalized to date, distinguishing between external and internal costs.

If significant internal costs are capitalized during an internal-use software development project, it could cause substantial fluctuations of expenses between periods that need to be explained.

Other Comments and Suggestions

Paragraph 10 indicates that the accounting for costs for reengineering operations and for costs of converting data from old systems to new systems is excluded from the scope of this proposed SOP. We suggest that the scope of the proposed SOP be expanded to include the accounting for such costs.

Because paragraph 18 addresses the preliminary stage of a software project, we presume strategic decisions about allocating entity resources among projects would have already been made. It therefore seems more appropriate for the type of alternative illustrated in the first bullet to be, for example, whether to develop a new payroll system or to correct problems in the existing payroll system.

We suggest that paragraph 26 state that entities should use contemporaneous record keeping to determine the payroll costs to be capitalized as internal-use software.

Paragraph 61 states that capitalization should begin when management believes that it is probable that the project will be completed and the software will be used to perform the function intended. Management beliefs are difficult, if not impossible, to audit. We suggest that in both paragraphs 20 and 61 *believes* be changed to *concludes*. It would also be helpful if illustrations of indications of management reaching such a conclusion were provided, such as budgeting funds to complete the project or minutes of board meetings where the decision was made.

We would be pleased to discuss any of our comments with the Task Force or AcSEC at their convenience.

Sincerely,

Joseph Graziano

Joseph Graziano
Eastern Regional Director of Assurance Services

Author: MIME:chasp@ms.com at INTERNET
Date: 5/9/97 8:12 AM
Priority: Normal
TO: Daniel J. Noll at AICPA3
Subject: exposure draft

------------------------------------ Message Contents ------------------------------------

Dan, it may be too late to comment on the sop on internally developed software but I thought the document was good conceptually but should have stated more clearly that packaged software can be capitalized and does that include upgrade fees and subscription based licenses? Increasingly, more organizations will purchase rather than develop applications. And there probably should be a specific statement as to Year 2000 fixes/enhancements - some of those projects will intermingle fixes with significant enhancements.

Also, what's the latest status on the exposure draft? thanx, chuck

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May 12, 1997

Mr. Daniel Noll
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Dear Mr. Noll:

Attached is our response to AcSEC's December 17, 1996, Exposure Draft, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

Very truly yours,

Richard Dieter

Enclosure

April 9, 1997

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We are pleased to have the opportunity to respond to the proposed statement of position (SOP), *Accounting for the Costs Of Software Developed or Obtained for Internal Use* (the "ED").

Overall Conclusion

We believe that the ED provides appropriate guidance on a topic that has traditionally been considered a "soft asset". While we realize that some constituents are uncomfortable with the notion of capitalizing what are perceived to be soft costs, we believe that the ED is merely recognizing the economics of the marketplace. It is undeniable that enterprises commit large sums to the development of internal software systems and equally undeniable enterprises do so because they expect to reap strategic and operating benefits in future periods. Of course, many investments in advertising and in basic or applied research and development could be perceived in the same manner.

The crucial difference between internally developed software and these other soft assets is that an enterprise has the ability, in most cases, to accurately predict the outcome of such investments. Technological feasibility is usually not in doubt — these characteristics of internal software development are very much like those of any other fixed asset. We believe that it is proper financial reporting to capitalize assets that embody probable future benefits and that can be reasonably measured. Internally developed software meets these criteria.

We support the issuance of the ED as a final SOP. It provides appropriate accounting guidance for many of the developments that have occurred in the evolution of computer software since the issuance of FASB Statement 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed* in 1986. We support the application of a fixed asset model to internally developed computer software. We also support the inclusion of additional guidance in the form of examples.

The general issue of accounting for intangible assets and other soft assets is a topic receiving broad interest from financial statement preparers and users, as well as auditors, regulators, and standard setters. The subject of the ED seems to be a good place to start to address this matter.

Distinguish Between Software Development and Content Development

We believe that the ED needs to make a better distinction between *software* development costs and *content* development costs and explain the accounting for each. This distinction takes on increasing importance with the rapid expansion of internet and intranet software developments. The distinction between software and content is perhaps best explained with examples:

Example 1: A bookseller with a large and profitable catalogue operation purchases software that allows it to post copies of its book inventory on the internet. The software also provides search and indexation features and an online order form so visitors may purchase books over the internet.

Example 2: A law firm develops an intranet research tool that allows firm members to locate and search the firm's databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database. Several members of the law firm are employed full time developing and maintain the information in the database.

Example 3: A large manufacturing firm places its procurement requirements in an internet site through which potential suppliers can download specifications, quantity needs, and delivery data. Suppliers may also post their bids to fill these contracts online. While the basic framework of the site does not change, the information put out for bidding is constantly changing.

Example 4: A professional services firm creates a website for the initial purpose of promoting the image and name of the company and for advertising[1] its products.

In each of these examples, the construction of the "software" (search engine, system "shell", annotation features, etc.) is entwined with the development of "content" or the information to be placed into the software "shell". An example would be the distinction between purchasing database software and accumulating customer purchasing patterns data (content). Another example would be to the development of internal accounting system software, which we believe is an asset that should be capitalized and amortized over its expected life. However, the transactions stored in that system are not capitalizable assets; they are content. We believe that content costs are distinguishable from software costs and merit different accounting treatment.

The distinction between content and software is not made in the ED. For example, the purchase price of a research database system factors in the cost of developing the software as well as building the content. If an enterprise constructed an identical database itself, the ED states it is "desirable for the costs of internally developed...computer software...be no different that the capitalized costs of purchased software...."[paragraph 66] Does this mean, whether purchased or internally developed, that only the "software" development costs should be capitalized? This interpretation of

[1] Accounting for advertising costs is covered by Statement of Position 93-7, *Reporting on Advertising Costs.*

the ED implies that content costs are *never* capitalizable even if embedded in the purchase price of an outside database. We believe this interpretation is inconsistent with current practice and other authoritative literature. Another possible interpretation is that both software and content development costs be capitalized. This implies that content costs are *always* capitalizable, that is, internal content development costs must be capitalized. We believe this interpretation is also inconsistent with current practice and other authoritative literature. The third possible interpretation is that content costs are outside the scope of the ED.

We consider internally developed content to be analogous to other internally developed intangible assets and that content development costs should, for this reason, be accounted for in a manner consistent with APB Opinion 17, *Intangible Assets*. Consistent with Opinion 17, content developments costs should be capitalized and amortized over their useful lives if purchased but should be written off as period costs if incurred internally. In any event, we believe the final SOP should address the matter.

Clarify When Capitalization Should Begin

While we generally agree with the approach taken in the ED, we are concerned that the first bullet in paragraph 20 is not sufficiently clear as to the nature of management's authorization. We believe that there should be an explanation in the final document that makes it clear that management's authorization of and commitment to the project can be implicit as well as explicit. The existence of a pattern of significant expenditures that would otherwise qualify for capitalization under the ED should create a presumption that a software asset is being developed and that the relevant costs should be capitalized. Otherwise, it may be possible to finesse the accounting requirements of the ED, depending on management's formal actions.

Clarify Scope

We agree with AcSEC's decision that the accounting for reengineering costs is beyond the scope of the project. However, we believe the reference to reengineering costs in paragraph 10 is too vague and that a parenthetical addition to the first sentence of paragraph 10 incorporating wording like "i.e. the development of systems or processes to feed data into the system" would clarify AcSEC's intent.

Additional Examples Including Website Development Costs

Overall, we support the inclusion of examples of the application of the ED. We have recently encountered practice questions related to the costs of developing Internet Web sites. We believe that the inclusion of several web site development examples in the final SOP would anticipate an emerging practice issue and provide valuable guidance. AcSEC may want to use examples similar to those included in the "Distinguish Between Software Development and Content Development" section of this letter. With these examples, AcSEC could additionally address the interconnection between the ED and SOP 93-7, *Reporting on Advertising Costs.*

Treatment of Long-term Licensing Agreements

The ED appears to contemplate licensing arrangements that involve only a single payment. Some software licensing agreements have continuing licensing payments over many years. FASB Statement 13, *Accounting for Leases,* specifically excludes computer software from its scope. AcSEC should modify the first bullet point (perhaps by footnote reference) in paragraph 26 to (1) acknowledge the fact that these agreements exist, and (2) refer to Statement 13 as the most analogous guidance in measuring the asset acquired in a long-term software licensing arrangement.

Specific Issues Raised by AcSEC

Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

We believe that an internally developed software application represents a long-lived asset for reasons similar to those set out in paragraphs 50 - 59 of the ED. We also believe that it is inappropriate to allow entities the discretion of whether to capitalize costs of software development for the reasons stated in paragraph 60 of the ED. We do not believe that such discretion is consistent with the concept of internally developed software being a long-lived asset. While we realize that there will be some implementation costs of the ED for users, mainly in adapting accounting systems to identify capitalizable expenditures, our intuition is that these incremental costs are not sufficient to offset the improvement in accounting for software assets and the additional comparability between enterprises that the proposed accounting will provide. We are hopeful that users of financial statements will provide AcSEC with their perspective on the matter.

Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We agree with the ED on this issue.

Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement 121, *Accounting for the Impairment of*

Long-Lived Assets to Be Disposed Of? **If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?**

We generally find the guidance contained in the ED on impairment to be both helpful and adequate. However, we suggest that one more bullet point be added to paragraph 28 that reads: "Significant changes in the original estimate of time needed to complete the modification or development of the software."

Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use?

FASB Statement 2, *Accounting for Research and Development Costs* provides sufficient guidance as to which costs are research and development. We recommend deleting paragraph 45 in the basis for conclusions, and especially recommend the discussion regarding technological feasibility in that paragraph be deleted. We believe that (1) this is not always true, and (2) the paragraph is not helpful to understanding AcSEC's model.

Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software? Why? What costs should be included or excluded?

In general, we agree with the approach taken in the ED. Please refer to our previous comments.

Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

Yes, for the reasons stated in the ED.

Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement 86, but not both? If not, how should those costs be allocated?

Yes, for the reasons stated in the ED.

The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

In general, we agree with the approach taken in the ED. Please refer to our previous comments regarding the distinction between content development and software development.

Other Comments

1. Paragraph 17. The term "pilot project" is unclear. Pilot for what?

2. Paragraph 46 in basis for conclusions. The phrase "regardless of whether..." is properly not in quotes but the placement seems misleading. Please clarify the sentence.

3. Paragraph 47 and 48 in basis for conclusions. Both paragraphs are confusing to read. Please clarify what is meant by these two paragraphs.

4. Paragraph 58 in basis for conclusions. But tangible assets can always be sold for some price. Is this always true of software?

5. Last sentence of paragraph 66 of basis for conclusions. Delete. This is a poor example to make the point in the rest of the SOP. Refer to our comments on the distinction between software development and content development costs.

6. Appendix A. Is (10) correct? Refer to our earlier comments on content costs vs. software costs. Is (19) correct? Is this really "not internal"? Or is it an internal cost to be expensed as research and development?

We would be pleased to discuss any of our comments with the Task Force or AcSEC at their convenience.

Very truly yours,

Arthur Andersen LLP

PHILIP MORRIS
COMPANIES INC.
120 PARK AVENUE, NEW YORK, N.Y. 10017-5592. TELEPHONE (212) 880-5000

May 15, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

We appreciate the opportunity to submit our comments to you on the Exposure Draft on Proposed Statement of Position, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (the "Exposure Draft"). Our comments on this proposal are set forth below:

Capitalization
Technology and access to it, is rapidly increasing in importance to all companies and as such, we acknowledge the need to re-evaluate the accounting issues associated with software development. However, based on our experience, we disagree with the Exposure Draft's requirement to capitalize costs of computer software developed or acquired for internal use. Further, the record-keeping burden of tracking costs, particularly internal costs, will generally be higher than the benefits derived from capitalization. Depending on the intended use and expected future benefits to be derived from the software, capitalization may or may not be appropriate. Accordingly, we encourage an approach that provides companies the choice to expense or to capitalize costs, based on criteria including software use and expected life. Comparability concerns raised by this approach could be satisfied with adequate disclosure of the accounting policy.

In our view, it is difficult to consistently conclude capitalization is the right accounting for all software development costs. In fact, the end-purposes cited in paragraph 50 of the Exposure Draft for capitalizing long-lived assets, such as reducing costs, increase the efficiency and improving competitive positioning - are often the same end-purposes for which companies undergo a restructuring. Restructuring costs are generally required to be expensed in the period management commitment and approval are obtained. Further, the analogy that software development is similar to building a building is somewhat extreme. Software development is a process - not a capital improvement. The dynamic nature of technology and software users' changing needs preclude software development costs from providing the same long-term benefit as provided by conventional long-lived assets.

For these reasons, we recommend the capitalization of software development costs when it is probable that the software will provide significant and incremental functionality - a framework similar to AcSEC's proposed guidance for capitalizing software upgrades.

Record-keeping
The Exposure Draft's requirement to include as capitalizable costs certain payroll and payroll-related costs and interest costs, creates an additional administrative task. In fact, the majority of our operating companies indicated that this provision would be extremely time-consuming, and due to varying useful lives of the related software, would provide a limited discernible benefit. Accordingly, we do not support capitalizing internal costs related to software development.

As an aside, we question the reasons for including "direct" time, but excluding training time spent by employees. Training and related costs are often a substantial component of the software development process and their exclusion seems arbitrary. If the proposal continues to require capitalization of employee costs, we recommend a re-evaluation of the internal costs eligible for capitalization.

Effective Date and Transition
The Exposure Draft currently requires implementation in 1997, with comments and redeliberations scheduled for the second quarter of 1997. Due to this timing, issuance of a final document in 1997 may be difficult.

In our view, issuance of a proposal and early adoption in that same year is not prudent, unless the likelihood of the proposal changing in substance or timing is remote, we had a similar concern with the issuance of Statement of Position 96-1, Environmental Remediation Liabilities. The proposal was issued in 1995, but the final statement was not issued until October 1996. Unfortunately, the actual final document was not available until late November 1996, with implementation required as of January 1, 1997. This timing made preparing disclosures required by Staff Accounting Bulletin No. 74 unusually difficult and the process, in our view, was unreasonable. We recommend a wider and more thorough communication of changes and timing of proposed statements to the accounting constituency.

Accounting for "Soft" Costs
We are concerned with the course AcSEC appears to be taking with respect to the accounting for soft costs. Our concern began a few years ago, with the Statement of Position on advertising, which permitted companies to effectively carve-out and capitalize "direct-response" advertising. Our concern is heightened with this recent proposal to capitalize all software development costs.

This trend toward capitalization is not conservative accounting and in many cases, a solid rationale for capitalization is absent. In our view, current and future earnings may be distorted by these practices.

<u>Other</u>
Finally, we believe a number of issues in the proposal require clarification.

First, the diagram in paragraph 16 indicates a potential for overlap between the design and testing functions included in the preliminary project stage (which are expensed) and the program instruction stage (which are capitalized). Additional examples may help clarify which design and testing activities should be expensed and which ones should be capitalized.

Second, paragraph 17 states pilot projects should be expensed. This raises the issue as to whether pilot programs should be expensed on the basis of location, division or project. Again, clarification would be helpful.

Third, paragraph 10 states that costs of re-engineered or upgraded applications are not eligible for capitalization. AcSEC's basis for excluding these costs and additional clarification to assist in distinguishing between software and systems development costs would be helpful.

Once again, we appreciate the opportunity to comment on the proposed document. We hope these comments are helpful to you during your re-consideration of the proposal and the relevant issues.

Very truly yours,

Frank T. Toscano

Frank T. Toscano
Vice President and Controller

FTT:af

FMC Corporation

Executive Offices
200 East Randolph Drive
Chicago Illinois 60601
312 861 6000

FMC

May 12, 1997

Mr. Daniel Noll
Technical Manager, Accounting Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10035-8775

File Reference No. 4264

Dear Mr. Noll:

FMC Corporation appreciates the opportunity to comment on the AcSEC's Exposure Draft "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". FMC supports AcSEC's efforts to develop a Statement of Position which would provide guidance on accounting for the costs of computer software developed or obtained for internal use. Upon review of the details of the Exposure Draft, we believe that the Statement of Position, as proposed, has met its intended goal. We have commented on specific questions raised in the Exposure Draft below:

Issue 1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs?

We agree with AcSEC that the costs of computer software developed or obtained for internal use should be recognized as assets. Computer software, like any other long-lived asset, provides a benefit to entities over a number of years and, therefore, the cost of such software should be expensed over the period benefited. In order to enhance comparability of financial statements between enterprises we believe that all entities should be required to capitalize, and thus not have the option to expense, these software costs.

Issue 2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified?

We believe that the SOP should not specify a maximum period for amortization or methods of amortization. We believe that the amortization period of software costs will vary based upon the type of internal software and the nature of the entity using the software (i.e. whether the entity is in an industry where it is common to change its software on a more frequent basis or retain its software for a number of years). Management clearly is in the best position to determine the appropriate useful life of the asset, subject, of course, to existing guidance such as Statement of Financial Accounting Standards No. 121 regarding impairments.

Issue 5: Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

In general, we believe that the proposed SOP has provided adequate guidance in terms of the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. However, it is not clear from reading the proposed SOP whether the costs of transferring data from the old software to the new software should be capitalized or expensed. We believe that these costs should be capitalized as the system will not be ready for its intended use until the data is transferred from the old software to the new software.

Again, we appreciate the opportunity to comment on this topic. We would appreciate your consideration of the items described above as you continue your deliberations.

Very truly yours,

Michael J. Callahan
Executive Vice President and Chief Financial Officer

National Securities Clearing Corporation
55 Water Street, New York, NY 10041
(212) 412-8402
Telex No. 5106001991 NSCC NYK

Robert S. Bennett
Controller

May 22, 1997

Mr. Daniel Noll, Technical Manager
Accounting Standards - File 4262
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Noll:

This letter sets forth the comments of National Securities Clearing Corporation (NSCC) on the proposed statement of position on "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use." NSCC appreciates the opportunity to comment on the proposed statement and recognizes the effort the American Institute of Certified Public Accountants to minimize the inconsistencies in the application of the related accounting principles.

NSCC believes that the implementation of this position will cause NSCC to incur additional cost without improving the quality of the financial information presented. Further, NSCC's income statement and cash flows will be distorted during a period which coincides with the average life of the capitalized software. Therefore, NSCC recommends that this standard not be implemented. Alternatively, NSCC believes that those entities whose financial statements are distorted by implementation without a corresponding improvement in the quality of the related financial information should be exempted from this standard.

Background

NSCC, a clearing agency registered with the Securities and Exchange Commission, provides various services to the financial community, consisting principally of securities trade comparison, recording, clearance and settlement. In 1996, NSCC processed approximately 979 million shares daily which represent all of the shares traded on the New York Stock Exchange, American Stock Exchange and the NASDQ market place.

The sophisticated computer systems used to process these transactions were developed over several years and are subject to regular maintenance and periodic upgrade. The funds expended to maintain and upgrade these systems have remained relatively stable over several years and are written-off in the year incurred. NSCC's cost accounting system measures the cost of the maintenance and upgrade of these systems. Overhead costs are assigned to maintenance and software development activities.

NSCC is an industry utility which operates close to a break-even point charging its customers an amount which approximates its cost. Therefore, cash flowing into NSCC from revenue closely approximates the cash flowing out for expenses.

NSCC's Position

There are four major reasons that lead NSCC to conclude that this exposure draft should not be adopted:

- If the exposure draft is adopted, it will cause NSCC to exclude certain capitalized costs from the determination of net income over the next several years. The duration of this reduction will coincide with the average life of the initial software capitalized. The exposure draft has the effect of reducing expenses over this period. Since NSCC expenditures on its software have been relatively stable in the last few years, NSCC's current practice of expensing such costs in the year incurred does not distort the income statement. The impact on NSCC's balance sheet will be immaterial. Therefore, NSCC's conclusion is that this change will not add value to the financial statements in the long run and will distort total expenses in the short run.

- In connection with above impact on expenses, NSCC's cash flow is also distorted. Since NSCC seeks to bill its customers an amount which approximates its expenses, the reduced expenses in the early years which result from adoption of the statement result in reduced cash flow. Therefore, NSCC will be required to find another method of funding internal software development.

- NSCC's cost accounting system records cost on a basis which is different from the one required in the exposure draft. Therefore, NSCC will be required to develop a system which can track software costs for two separate standards. This revised system will be costly to maintain.

- The standard will require NSCC to capitalize such software after the "... conceptual formulation, design, and testing of possible software project alternatives ... have been completed." NSCC believes that it may prove difficult to determine the point when capitalization should begin.

Summary

NSCC has concluded that the exposure draft will cause additional cost without adding value and NSCC's income statement and cash flows will be distorted in the short run. Therefore, NSCC recommends that it not be adopted or those entities whose financial statements are distorted by implementation without a corresponding improvement in the quality of the related financial information should be exempted from this standard.

Very truly yours,

Robert J. Bennett

Vice President

workyear.97/noll.rsb

Charles Schwab

THE SCHWAB BUILDING • 101 MONTGOMERY STREET • SAN FRANCISCO, CA 94104 • (415) 627-7000

May 29, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards, File 4262
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Exposure Draft of a Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed Or Obtained for Internal Use*

Dear Mr. Noll:

We are pleased to comment on the AICPA's Exposure Draft of a Proposed Statement of Position, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,* dated December 17, 1996 (the "Exposure Draft"). Reflecting our high degree of concern over issues raised by the Exposure Draft, this marks the first time our firm has commented directly on an AICPA exposure draft.

We agree with the AICPA's position that there is a need for consistency in accounting for the costs of computer software developed or obtained for internal use and we commend the AICPA's efforts in addressing this issue. However, we remain unconvinced of the economic benefits of the Exposure Draft and the advisability of its approval by the AICPA for the reasons discussed below. Since we believe that the Exposure Draft will have the greatest impact on the costs of computer software developed for internal use, our comments focus accordingly.

1. We do not believe that the Exposure Draft's primary objective of consistency in accounting for the costs of computer software developed for internal use will be accomplished. The proposed criteria for capitalization is highly subjective — it allows for judgment and flexibility by management for determining costs, timing, estimated useful lives and valuation methods. By the very nature of these costs, the timing, estimated useful lives and valuation methods will vary significantly from one company to the next resulting in inconsistent capitalization.

2. There is a high risk associated with the development of computer software since it is fraught with the effects of cost over-runs, abandonment and technological obsolescence. This risk allows for the potential of recording assets on the balance sheet that do not equal their real or current value, and will, therefore, be constantly adjusted for asset impairment. This will cause a distortion in companies' reported financial condition.

3. We are very concerned about the expense we will incur to build the infrastructure to capture, monitor and value the costs of computer software developed for internal use as assets. This will require us to spend significant amounts of time creating systems and processes to track these projects since they would be outside of our current tracking procedures. Additionally, due to the subjectivity of the capitalization of the costs of computer software developed for internal use, management will have to focus valuable time on valuation issues rather than spend their time on business development and operational issues. This will cause significant expense and

inefficiencies for the company, and will not, in any way, increase the value of the company to its stockholders.

4. The capitalization of the costs of computer software developed for internal use will artificially inflate earnings. Because of this, the effects of capitalization will be "adjusted out" by the users of our financial statements in order to arrive at more meaningful and comparable financial information. The proposed treatment under this Exposure Draft will widen the distance between operating results calculated under generally accepted accounting principles and the adjusted results used by the financial community. In doing so, we reduce the credibility of our financial statements.

5. The Charles Schwab Corporation, through its broker-dealer subsidiaries, must maintain a required level of regulatory capital that is intended to provide protection for its customers' assets, as well as financial integrity and liquidity. In computing regulatory capital, assets that are considered illiquid are deducted. The capitalization of the costs of computer software developed for internal use will create such illiquid assets. These illiquid assets will reduce our regulatory capital and increase our cost of capital as additional capital will be required to offset the negative effects of these assets. This may pose similar problems for companies in other regulated industries.

Our position regarding accounting for the costs of computer software developed or obtained for internal use is as follows. We believe the costs of software <u>obtained</u> for internal use should be <u>capitalized and amortized</u> in accordance with standard accounting practices for purchased assets since these assets have a determinable value (i.e., purchase price) and determinable useful life. Alternatively, the costs of software <u>developed</u> for internal use should be <u>expensed as incurred</u>. This is the most proper and conservative method of accounting for these costs and would eliminate any subjectivity and inconsistency of capitalization, amortization and valuation among entities and industries. Additionally, this treatment is more compatible with the Securities and Exchange Commission (SEC) historical stance regarding such costs[a].

We strongly recommend that the AICPA reconsider its position on this matter. We believe that our position is the most proper, conservative and consistent method of accounting for these costs and would provide users of our financial statements with a relevant measurement of the company's operating performance.

Please feel free to contact me at (415) 636-5271 with questions regarding our comments. I have enclosed a copy of our 1996 annual report as background information.

Very truly yours,

Michael Bentivoglio
Vice President
Planning, Reporting and Taxation

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[a] The capitalization and amortization of the costs of computer software developed for internal use appears to be contrary to the SEC's historical stance regarding these types of costs (i.e., research and development costs, account acquisition costs, store opening costs and advertising costs). The SEC has historically favored a conservative approach of expensing such costs as incurred rather than capitalizing and amortizing them over a period of time.

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Kathy A. Asbeck
Vice President
and Controller

CORNING

June 2, 1997

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262

Dear Sir:

We have reviewed the Exposure Draft (ED) of the proposed Statement of Position (SOP), *Accounting for the Costa of Computer Software Developed or Obtained for Internal Use*, and appreciate this opportunity to present our views for your consideration.

Overall, Corning agrees with the general direction of the SOP as well as its objective of improving financial reporting and disclosures for what has become a significant unrecorded asset for many entities. A final SOP based on the ED, except as noted in the attached responses, will provide a reasonable methodology to record and disclose the costs of internal-use computer software.

We feel strongly, however, that entities should continue to have the flexibility to adopt this standard to fit their individual company's own facts and circumstances. For example, capitalization of internal-use computer software should not be required when the costs to do so would exceed the benefits.

We have responded to each of the eight issues of the SOP on the following pages. We would be pleased to discuss our comments further with you or your staff.

Sincerely,

Kathy A. Asbeck

Kathy A. Asbeck

KAA/ne

1. *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

We believe that the costs of computer software developed or obtained for internal use meet the characteristics of an asset and should be recognized as assets.

However, we believe that entities should continue to have the flexibility of either expensing or capitalizing internal-use computer software where the cost of capitalization exceeds the benefit of reporting such costs as assets. The use of judgment with respect to determination of expense/capitalization thresholds should be encouraged. If material, disclosure of an entity's accounting policy should be required in the annual financial statements. If an entity decides to capitalize software, the SOP would provide guidance regarding costs to be capitalized versus expenses.

The costs of reporting include the development and maintenance of a project tracking system, similar to that which is used for self-constructed fixed assets and a system for capitalization of interest during development.

2. *Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

We agree with AcSEC's decision to not specify a maximum period for amortization or a method of amortization in the SOP. We believe that each entity is better able to determine an appropriate useful life and method of amortization.

3. *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

We support the use of FASB Statement No. 121 in making determinations of impairment as this would be consistent with the recognition of impairment for other long-lived assets. Capitalized software should be considered with other tangible and intangible long-lived assets of a business when impairment is being considered.

4. *Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

   We believe that costs of internal-use computer software should be capitalized based on principles similar to those for other long-lived assets. As such, we agree that technological feasibility does not apply to this sop. We believe that only costs that will provide a future benefit should be capitalized. In that regard, entities should continue to have the flexibility to fit their individual company's own facts and circumstances. A key element in applying judgment is management's assessment of the probability of successful implementation and achievement of design functionality.

5. *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

   We believe that the SOP is too narrowly written in terms of the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. Other related internal support costs should also be capitalized but only if incurred incrementally to ongoing business activities. Only truly unrelated costs such as corporate office expenses should be excluded. There is a potential inconsistency regarding the accounting treatment for such expenses which would be capitalizable when provided by external vendors (who will charge on a 'fully-loaded' basis), but expensed if incurred directly by the reporting entity.

6. *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?*

   We believe that the SOP and the examples provided in Appendix A provide sufficiently clear guidance to help entities determine when computer software is and is not intended for internal use.

7. *Do you agree with the approach in the proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

Consistent with the objective of the SOP to provide guidance for internal-use computer software and require continued application of the provisions of FASB Statement No. 86 for software to be marketed or sold, we agree that an entity should follow the guidance in either the SOP or the FASB Statement, but not both. We believe that costs of development can not easily or accurately be allocated between internal-use computer software and the same software when externally marketed.

8. *Is the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance provided in the SOP operational?*

We agree with AcSEC's decision that the costs of material upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures result in significant additional functionality. As with fixed assets, judgment will play a significant role in making allocations between upgrades or enhancements and maintenance. The guidance provided in the SOP reflects GAAP guidance for capitalization of improvements to any other long-lived asset. We believe that the guidance is sufficient to allow distinction of upgrades/enhancements from maintenance activities on a case by case basis.

FINANCIAL EXECUTIVES
INSTITUTE

June 11, 1997

Susan M. Koski-Grafer
Vice President - Professional Development

Mr. Daniel Noll
Technical Manager
Accounting Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4262

Dear Sir:

The Committee on Corporate Reporting (CCR) of the Financial Executives Institute (FEI) has reviewed the Exposure Draft (ED) of the proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and appreciates this opportunity to present our views for your consideration.

Our research indicates that there is a wide array of views regarding capitalization of internal-use software among the CCR members. This letter represents a balanced presentation of the majority view of CCR members. If a CCR member has a particular question or recommendation not addressed in this response letter, it will be included in their individual company's response letter. Overall, CCR agrees with the general direction of the SOP as well as its objective of improving financial reporting and disclosures for what has become a significant unrecorded asset for many entities. A final SOP based on the ED, except as noted in the attached responses, will provide a reasonable methodology to record and disclose the costs of internal-use computer software.

CCR feels strongly, however, that entities should continue to have the flexibility to adopt this standard to fit their individual company's own facts and circumstances. For example, capitalization of internal-use computer software should not be required when the costs to do so would exceed the benefits.

CCR also believes that an accounting practice area as broad as that covered by this SOP would be better addressed by the FASB. We urge AcSEC to focus its efforts on narrower areas of interpretation and clarification.

We have responded to each of the eight issues of the SOP on the following pages. We would be pleased to discuss our comments further with you or your staff. This response was developed by William Nowak of Eaton Corporation. Should you have any questions, please contact him at (216) 523-4179.

Sincerely,

Susan Koski-Grafer

Susan Koski-Grafer

x:\ccr comment letters\sop - internal-use software - final.doc

10 Madison Ave., P.O. Box 1938, Morristown, NJ 07962-1938 (201) 898-4607 FAX (201) 898-1207
e-mail: skg@fei.org

1. *Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits of reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?*

CCR believes that entities develop or obtain internal-use computer software for the same reason that they develop or obtain other long-lived assets, e.g., to operate more efficiently. As such, we believe that the costs of computer software developed or obtained for internal use meet the characteristics of an asset and should be recognized as assets.

However, we believe that entities should continue to have the flexibility of either expensing or capitalizing internal-use computer software where the cost of capitalization exceeds the benefit of reporting such costs as assets. The use of judgment with respect to determination of expense/capitalization thresholds should be encouraged. If material, disclosure of an entity's accounting policy should be required in the annual financial statements. If an entity decides to capitalize software, the SOP would provide guidance regarding costs to be capitalized versus expensed.

The costs of reporting include the development and maintenance of a project tracking system, similar to that which is used for self-constructed fixed assets and a system for capitalization of interest during development.

2. *Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?*

CCR agrees with AcSEC's decision to not specify a maximum period for amortization or a method of amortization in the SOP. We believe that each entity is better able to determine an appropriate useful life and method of amortization.

3. *Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?*

CCR supports the use of FASB Statement No. 121 in making determinations of impairment as this would be consistent with the recognition of impairment for other long-lived assets. Since the FASB Statement is the only impairment guidance that provides rules to follow, CCR believes it is a good framework to use; however, we recognize that judgment would need to be used to determine fair value of internal-use software as a cash flow analysis would be difficult to perform.

4. *Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?*

CCR believes that costs of internal-use computer software should be capitalized based on principles similar to those for other long-lived assets. As such, we agree that technological feasibility does not apply to this SOP. We believe that only costs that will provide a future benefit should be capitalized. In that regard, entities should continue to have the flexibility to fit their individual company's own facts and circumstances. A key element in applying judgement is management's assessment of probability of successful implementation and achievement of design functionality.

5. *Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?*

CCR believes that the SOP is too narrowly written in terms of the kinds of costs that should be capitalized in the measurement of internal-use computer software assets. Other related internal support costs should also be capitalized but only if incurred incrementally to ongoing business activities. Only truly unrelated costs such as corporate office expenses should be excluded. There is a potential inconsistency regarding the accounting treatment for such expenses which would be capitalizable when provided by external vendors (who will charge on a 'fully-loaded' basis), but expensed if incurred directly by the reporting entity.

6. *Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?*

CCR believes that the SOP and the examples provided in Appendix A provide sufficiently clear guidance to help entities determine when computer software is and is not intended for internal use.

7. *Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?*

Consistent with the objective of the SOP to provide guidance for internal-use computer software and require continued application of the provisions of FASB Statement No. 86 for software to be marketed or sold, CCR agrees that an entity should follow the guidance in either the SOP or the FASB Statement, but not both. We believe that costs of development can not easily or accurately be allocated between internal-use computer software and the same software when externally marketed.

8. *Is the guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance provided in the SOP operational?*

CCR agrees with AcSEC's decision that the costs of material upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures result in significant additional functionality. As with fixed assets, judgment will play a significant role in making allocations between upgrades or enhancements and maintenance. The guidance provided in the SOP reflects GAAP guidance for capitalization of improvements to any other long-lived asset. CCR believes that the guidance is sufficient to allow distinction of upgrades/enhancements from maintenance activities on a case by case basis.

Other

Given the time required to design and develop a project tracking system, CCR recommends that AcSEC make the new Statement of Position effective no earlier than one year after issuance. We would, of course, support an early adoption provision.

KPMG Peat Marwick LLP

1897·1997

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New York, NY 10022

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June 11, 1997

Mr. David Noll, Technical Manager
Accounting Standards, File 4262
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York NY 10036-8775

Dear Mr. Noll:

Exposure Draft for Proposed Statement of Position: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use

We support the issuance of a final SOP. The approach in the above named Exposure Draft issued December 17, 1996 is satisfactory. However, it is imperative that accounting guidance be provided for "costs of reengineering operations" and "costs of converting data from old systems to new systems."

These costs are excluded from the scope of the SOP in paragraph 10 of the Exposure Draft. The AICPA should determine if it can provide accounting guidance for these costs in a timely manner in the project related to this SOP or in the project related to "Reporting on the Costs of Start-Up Activities." If it is determined that providing accounting guidance for these costs would require reexposure and delay issuance of final SOPs, then AcSEC should ask the EITF to address the accounting for these costs. Additionally, we believe the final SOP should address the need to separate the portion of the purchase price of internal-use computer software acquired from a third party related to these costs (if included in the purchase price) in the same manner as training and maintenance fees in paragraph 27 of the Exposure Draft.

Responses to the questions included in the Exposure Draft's transmittal letter follow.

1: Should the costs of computer software developed or obtained for internal use be recognized as assets? Should entities have the option to capitalize or expense such costs? Do the benefits for reporting those costs as assets exceed the costs of such reporting? What are the costs of reporting?

Our long-time position has been to expense internal development costs unless certain criteria are met. While we believe that optional capitalization is preferable, we can accept the guidance contained in the Exposure Draft, subject to the above revision.

2: This proposed SOP does not specify a maximum period for amortization or methods of amortization. Should the SOP specify that amortization should not exceed a maximum period? If so, why, and what maximum period should be specified? Should the SOP require certain methods of amortization? If so, why, and what methods should be required?

We agree that the SOP should not specify a maximum period for amortization or methods of amortization.

3: Should impairment of internal-use computer software assets be recognized and measured in accordance with FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of"? If so, does this proposed SOP provide sufficient guidance for entities to recognize and measure impairment? If not, how should entities recognize and measure the impairment of internal-use computer software assets?

We agree with the guidance contained in the Exposure Draft.

4: This proposed SOP requires capitalization of certain costs of computer software developed or obtained for internal use, provided that those costs are not research and development. However, this proposed SOP does not require that an entity meet technological feasibility criteria (similar to that established in FASB Statement No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed") before it begins capitalizing qualifying costs. Should an entity be required to meet technological feasibility criteria before it may begin capitalizing the costs of computer software developed or obtained for internal use? If so, what are those criteria?

We agree with the guidance contained in the Exposure Draft. However, we believe the criteria in paragraph 20 that "management . . . believes that it is *probable* that the project will be completed and the software will be used to perform the function intended" should be emphasized. This is a substantive requirement that should be met before it is appropriate to capitalize cost. We believe this criteria is appropriate for developed internal-use computer software and serves the same function as "technological feasibility."

5: Is the proposed SOP too broad or too narrow in the kinds of costs that should be capitalized in the measurement of internal-use computer software assets? Why? What costs should be included or excluded?

We agree with the guidance in the Exposure Draft, subject to our previous comments.

6: Does the SOP provide sufficient guidance to help entities determine whether computer software is for internal use? Is this guidance appropriate? Why?

We believe adequate and appropriate guidance has been provided.

7: Software is sometimes developed or obtained for both internal use and external marketing. This proposed SOP requires that if all characteristics for determining whether computer software is for internal use are not met, the entity must account for the software in accordance with the guidance in FASB Statement No. 86. However, some believe that an entity should follow both the guidance in this proposed SOP and FASB Statement No. 86 when costs of computer software related to software that will be both used internally and marketed to others. They believe those costs should be allocated between internal-use software and software to be marketed. Do you agree with the approach in this proposed SOP that requires an entity to follow the guidance in either this proposed SOP or FASB Statement No. 86, but not both? If not, how should those costs be allocated?

We agree with the approach used in the exposure draft.

8: The proposed SOP provides guidance that distinguishes between computer software activities that are upgrades or enhancements and activities that are maintenance. Is that guidance operational?

We agree with the guidance contained in the Exposure Draft.

Very truly yours,

KPMG Peat Marwick LLP

KPMG Peat Marwick LLP

EWT/am